Financial Markets Impact on the Marine Insurance industry

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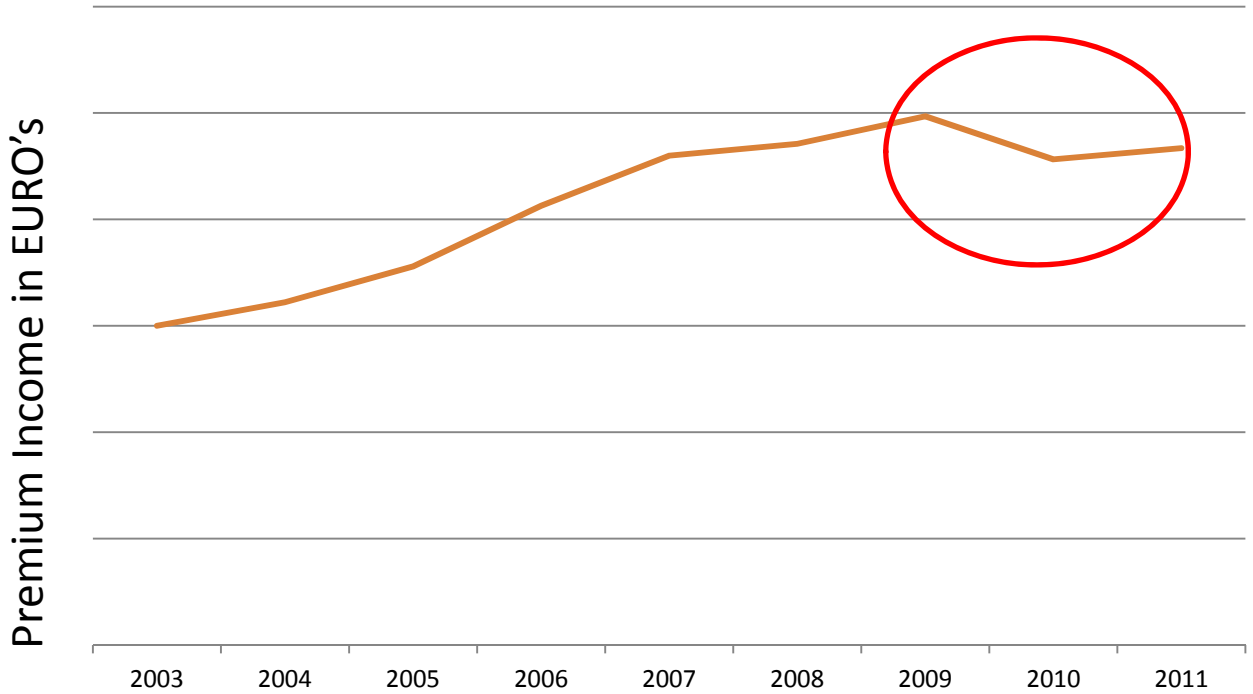
Remember IUMI Paris 2011 and the storm clouds……a perfect storm?

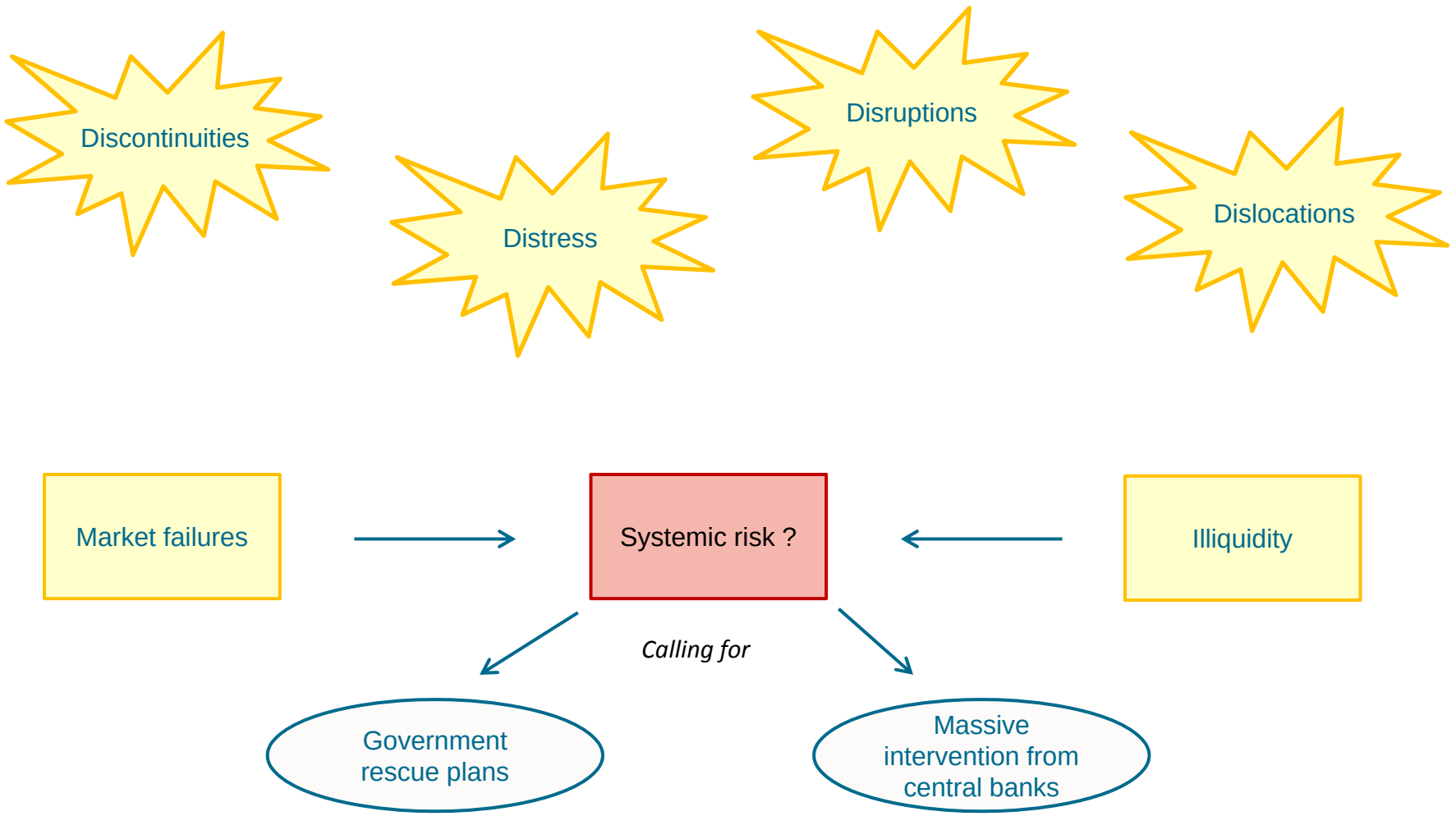
The everyday direct impact on Marine and Energy underwriting

- We all know that trade is down. A quick plot of some of our 422 cedant's cargo income gives us a combined similar premium income graph like this …



- Is this the Financial markets impact on our Marine Insurance industry ?

No. Macro economic events have hit hard. Marine Insurance is inextricably linked to world trade, which is inextricably linked to the world macro-economic environment;



somebody has to pay….

…and on top of that, large insurance shocks like catastrophic events…

2011 witnessed exceptionally high Natural Catastrophe activity, with more than $100bn losses (Source: AM Best as of April 2012) :

We should note that five of the most expensive catastrophes of all time have occurred in the past two years.

… and even more for Marine and Energy…

Underwriting year 2011 witnessed exceptionally high Marine and Energy losses in addition to Rena, Jupiter 1, Oliva, Petrojarl Banff…

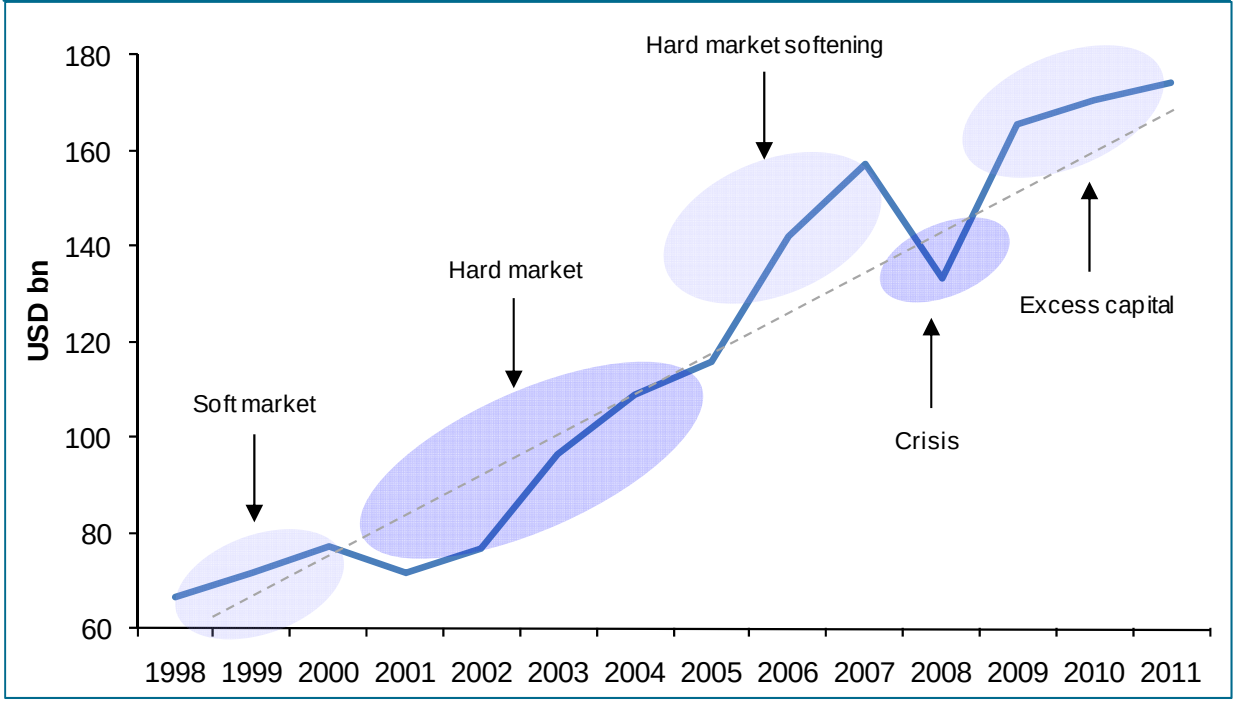
Costa Concordia

Gryphon A

…and then in 2012, Bareli, Bunga Alpinia, Cape Bari, Chamarel, Gelso M, KS Endeavour, MSC Flaminia, Stellar Daisy and Stolt Valor…..

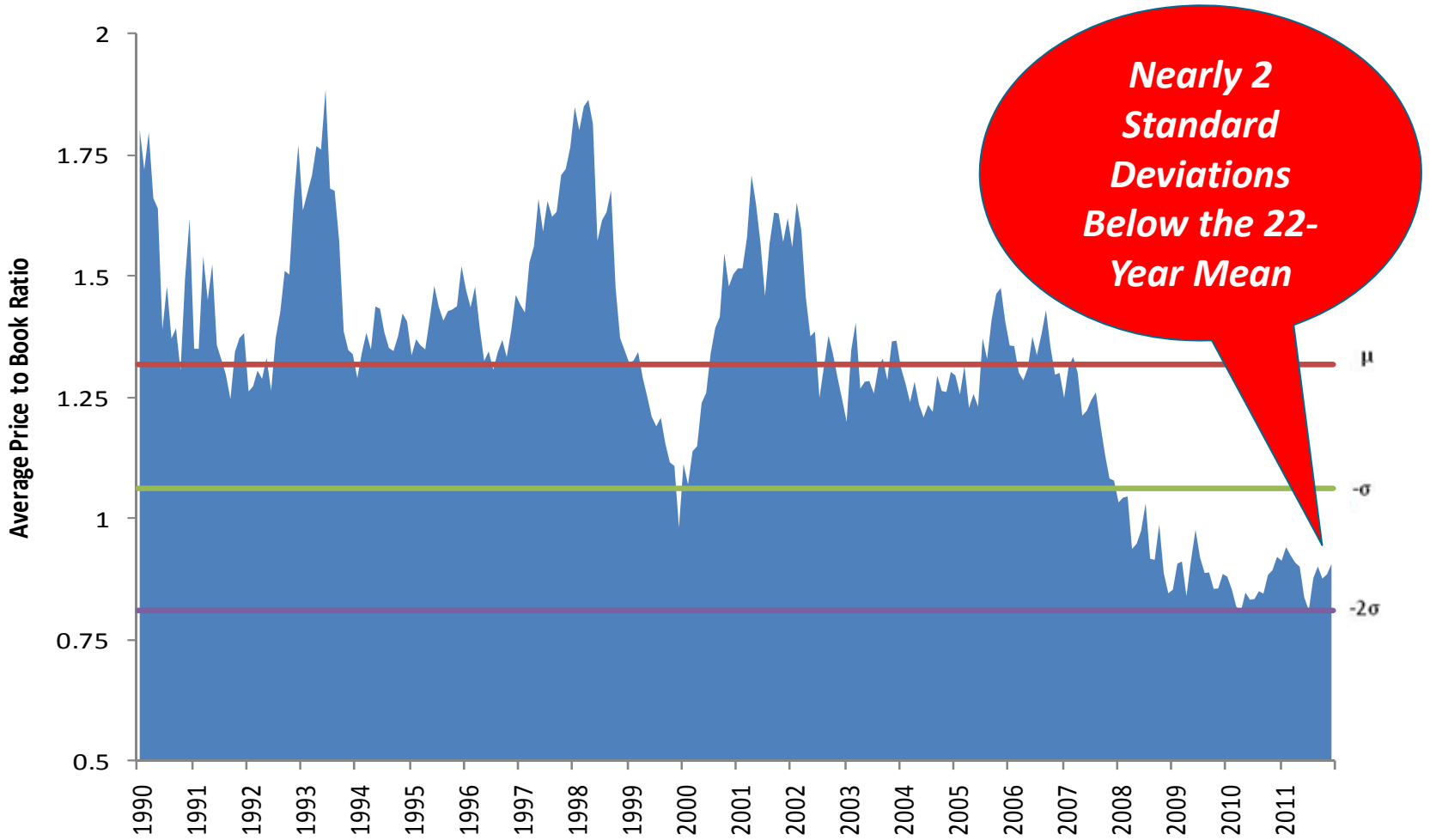
Even though apparent (re)insurance capacity has been steadily increasing, working capacity is in fact stable…

Long-term evolution of the Guy Carpenter Global Reinsurance Composite companies' shareholders' funds



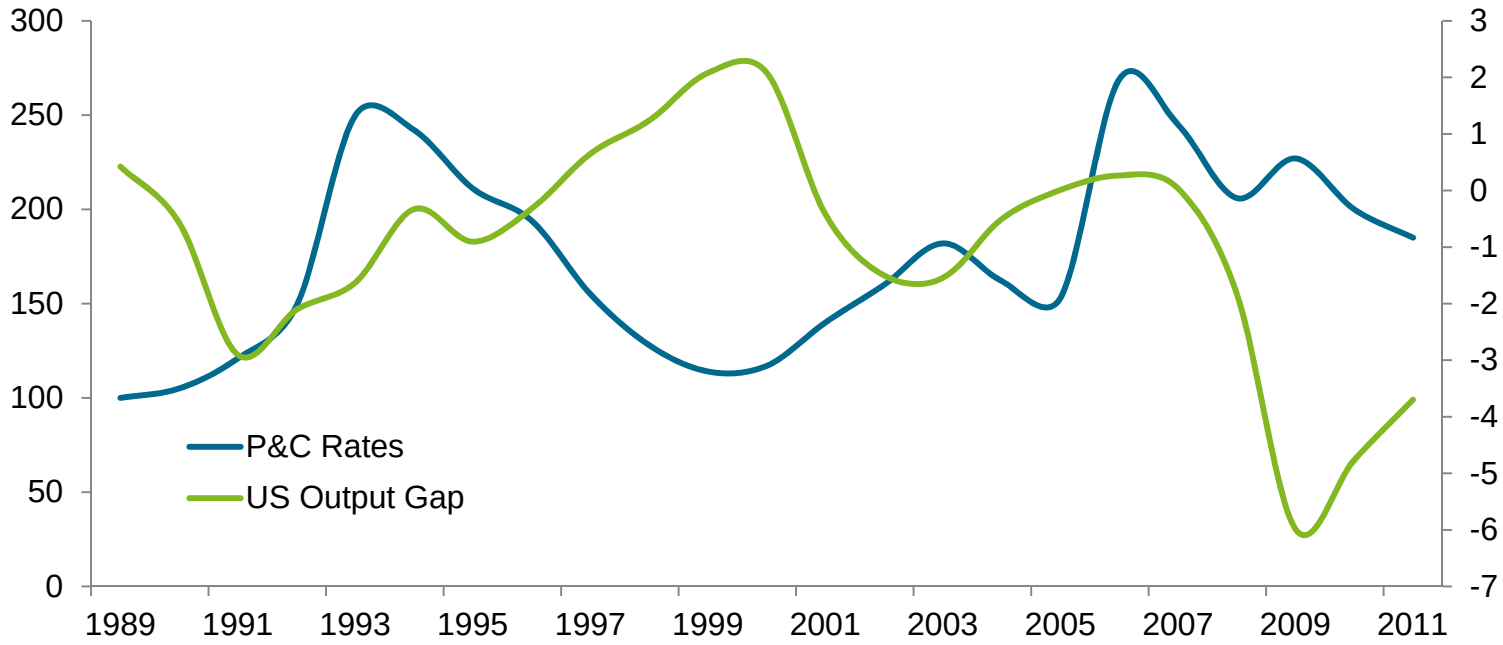
- At first glance, the (re)insurance industry appears to certain observers as overly capitalized
- However, recent Cat events have led the industry to re-assess its real exposures
- The (re)insurance industry has broadly remained disciplined so far, and "working" capacity has actually remained stable for some time now

… although they have been paying a high price for it: Reinsurers' average Price to Book ratios are near historic lows



The reinsurance industry offers a performance largely de-correlated from the wider economic situation

P&C reinsurance cycles differ from GDP growth cycles



Sources: GDP: IMF; Reinsurance Rates: Willis Re

But it is not as healthy as it may appear….

- **The industry has been hit and continues to be hit by the financial crisis**.

- Companies have suffered from :
  - sovereign downgrades (there are only 14 AAA-rated countries left)
  - continued distress in Portugal, Ireland, Greece and Spain leading to write downs (meanwhile, regulators and rating agencies still induce them to invest in government bonds)
  - impairments, capital losses, low yields on the asset side
  - Stock value hits due to (re)insurance stocks being lumped together with banks

..as the lingering effects of the global financial crisis will not go away…..

- The insurance industry was **not responsible for the financial crisis,** nor did it contribute to either the credit bubble or the financial market turmoil or bail outs (with one notable exception due to non-insurance activities).

- Up to now, **(re)insurers have been able to absorb those shocks**

- But **today's economic policies could create major challenges** for the industry in the future

- **«…the industry will not be able to live forever with low interest rates which limit insurers abilities to make money on capital investment while having to pay out guaranteed returns to customers…»** Nikolaus von Bomhard CEO Munich Re 17JUL2012

A tough era of recovery

- **There are different ways out:**
  - **Soft landing:** governments embrace fiscal discipline, and risk-adjusted interest rates rise progressively. This scenario would allow insurers to progressively increase their margins, reduce the current reinvestment risk and alleviate pressure to meet long-term guarantees.
  - **Hard landing:**
    - Increased taxation to recover market bail-outs
    - Sovereign and corporate defaults
    - Sharp rise in interest rates for all maturities
    - Brutal increase in the CPI : Back to inflation

* **...and** an even harder landing for Marine if China's economy stagnates, imports and exports reduce resulting in a massive effect on world trade

But there are three topics in particular that should be discussed;

- **INFLATION**
- **REGULATORS AND RATING AGENCIES**
- **INTEREST RATES**

INFLATION could break loose

- **Globalization, which has had an disinflationary effect so far**, may become inflationary because of persistent tensions in oil, raw materials and foods and growing tensions over wage purchasing power in emerging Asia (esp. China and India).

- If real interest rates are positive, returns on the asset side will partially compensate for that. But **if real interest rates are negative, inflation will bite hard.**

- Insurers will be all the more affected since **insurance goods and services tend to be more sensitive to inflation than CPI**.

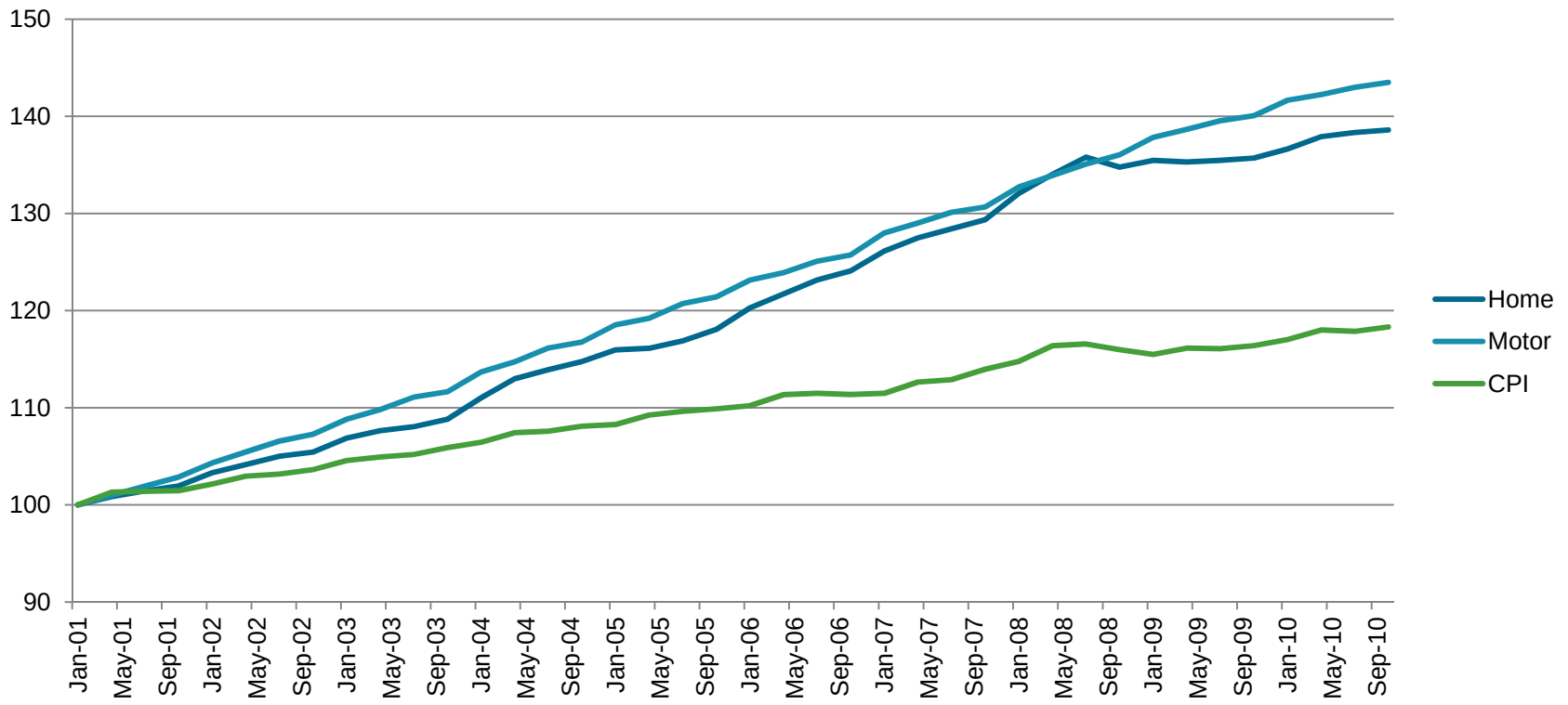
  - Motor and home insurance prices have increased significantly faster than CPI over the past 20 years – in the case of motor this is partly due to the cost of bodily injuries *(see next slide)*.

  - Long tail lines such as Casualty, (Med Mal and D&O in particular) and Credit insurance suffer most

  - An expected falling renewal rate in addition to Arson and other fraudulent claims issues

INFLATION in non-life insurance goods and services steadily exceeds CPI

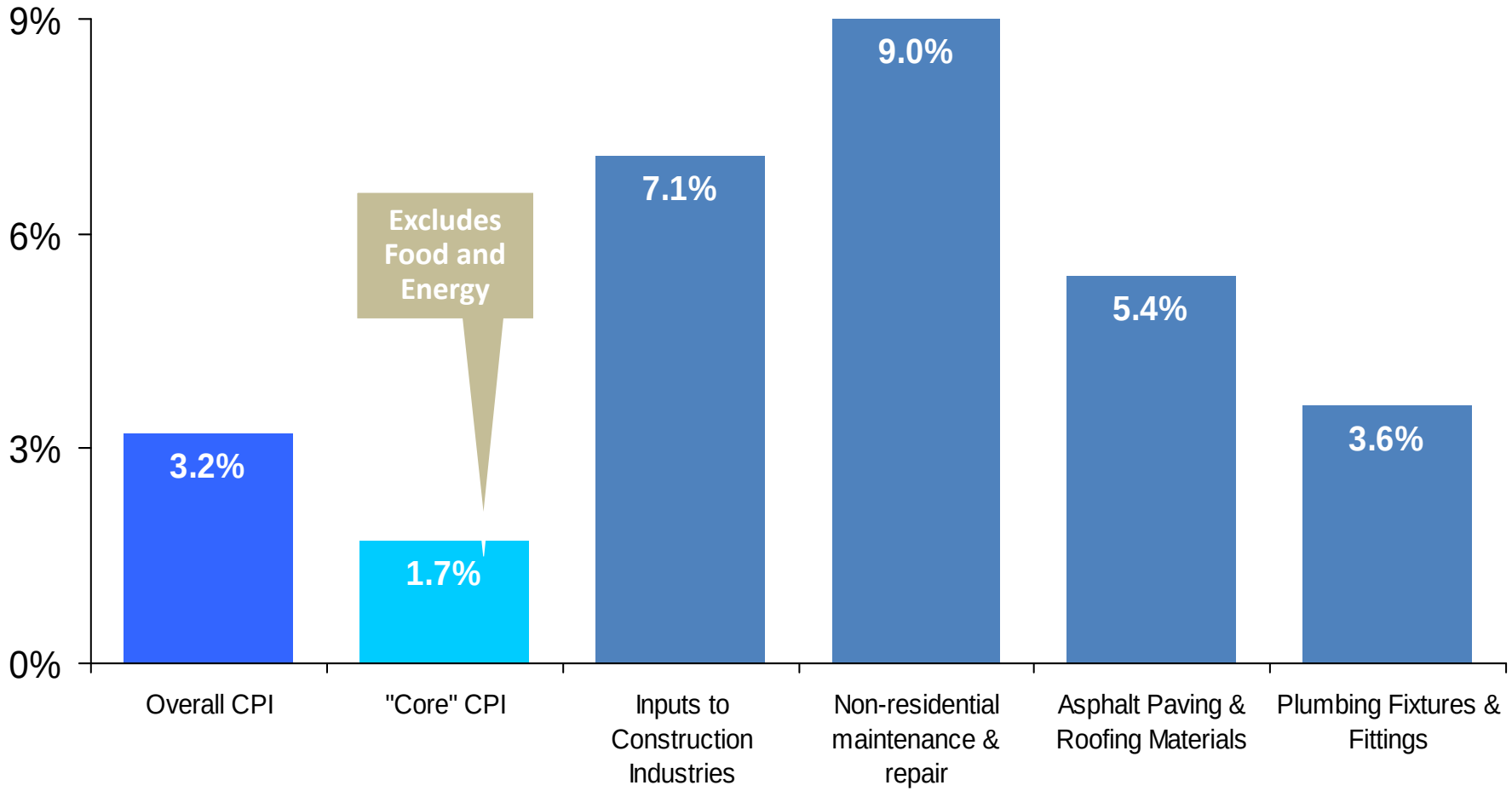
The example of France



Home & Motor: FFSA "Global Indexes" representing cost of a normalized claim with the same characteristics over time (in French home property / motor insurance);
French CPI, all items, quarterly averages;
Jan 2001 = 100 for the three series

P/C Commercial Property Insurance Claim Cost Drivers Grow Faster than the Overall CPI Suggests

Price Level Change: 2011 vs. 2010



Sources: Bureau of Labor Statistics; Insurance Information Institute.

THREE particular topics;

- INFLATION
- **REGULATORS AND RATING AGENCIES**
- INTEREST RATES

RATING - Regulators are well aware of the risks linked to interest rates

Rating agencies and regulators now follow Insurance company exposure to low yield risk very carefully

- For example**, EIOPA**, the European Insurance regulatory body, conducted a risk assessment exercise in 2011 asking national insurance regulators to indicate the risks faced by the insurance sector.

Risks	Average impact
Credit risk - Sovereigns	2.7
Interest rate risk - prolonged period of low interest rates	2.6
Interest rate risk - sharp increase with a resulting fall in bond prices	2.6
Natural Catastrophes	2.6
Credit risk - Corporates and private households	2.4
Equity risk	2.3
Property risk	1.9
Liquidity risk	1.9
Currency risk	1.7

Source: EIOPA, Rating Key: 1- Low, 2- Medium – Low, 3- Medium – High, 4- High

Interest rate risk has been identified as the most serious risk after credit risk linked to sovereign debt, before natural catastrophes and equity risk.

Sources : EIOPA

THREE particular topics;

- INFLATION
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- **INTEREST RATES**

INTEREST RATES

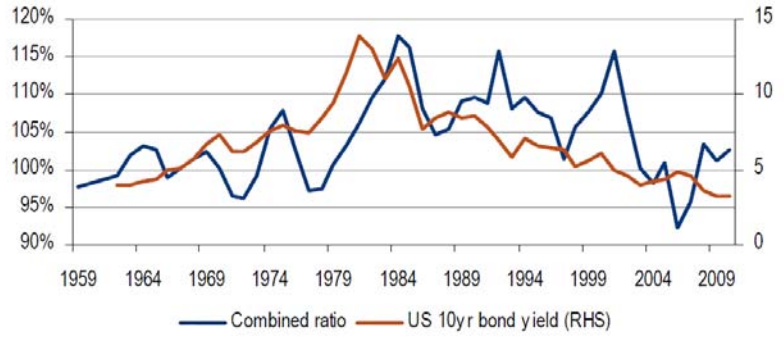
The interest rate dilemma

The problem with interest rates is that if they spike up, or down it is bad for our industry.

In a low interest rate environment, for a given combined ratio, lower yields generate less ROE.

(Re)insurers adapt by lowering their combined ratios

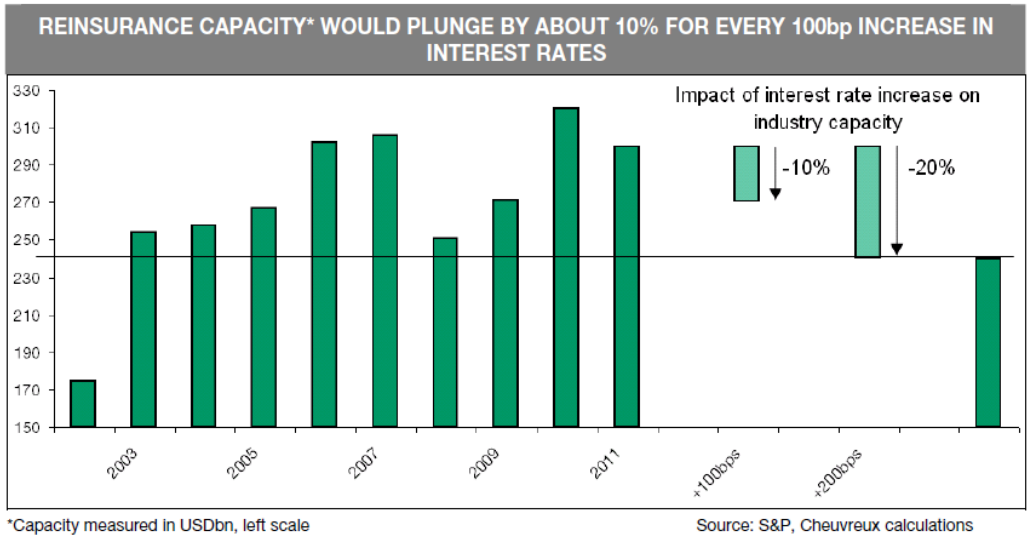
But can they do it quickly enough?



Note: the combined ratio is for the US non-life industry. Source: AM Best and Datastream.

INTEREST RATES. Low rates are bad but a sharp rise in interest rates would be just as bad for (re)insurers

- **Degradation of bonds** on the asset side, causing losses and impairments
- Life insurance In-force savings insurance products would suddenly become unattractive compared with newly available products. **High surrender rates would translate into cash outflows** and could force life insurers to sell their assets at lower prices.
- **Shareholders' equity would suffer** and solvency levels would fall



INTEREST RATES, we simply have to improve the combined ratio

- Germany and France now offer negative interest rates…..

  "….**it costs money to rent a safe**"….Denis Kessler, CEO SCOR

- **In the low yield environment your company now has to improve the combined ratio, just to maintain the same ROE to shareholders**.
  The improvement is at least equal to the reduction in interest rate, but almost certainly more.

- The amount of improvement will depend on your company profile as:
  - Rating
  - Diversification
  - Line of business mix and duration
  - Proportional and non proportional or capital intensive aspects dominate

SUMMARY

- Marine insurance is inextricably linked to world trade which is inextricably linked the macro economic environment
- Monetary policies and the knock-on effect on the financial market force (re)insurers to confront a challenging regulatory and macro-economic environment
- (Re)insurance companies are grouped with banks (who needed bail out assistance) and this leads to a negative perception of the (re)insurance sector
- A lowering or a surge in interest rates has a bad effect, any additional adverse regulator attention has a bad effect, and the break out of widespread inflation will severely hurt the (re)insurance industry

Those sailors who recognise the storm clouds on the horizon will be better prepared.

THANK YOU