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A.M. Best's Additional Stress Testing In Light of European Economic Uncertainty

Most insurers rated by A.M. Best operating within the eurozone currently demonstrate robust balance sheets. However, the ongoing market turbulence within the region and recessionary pressures threaten to undermine this strength.

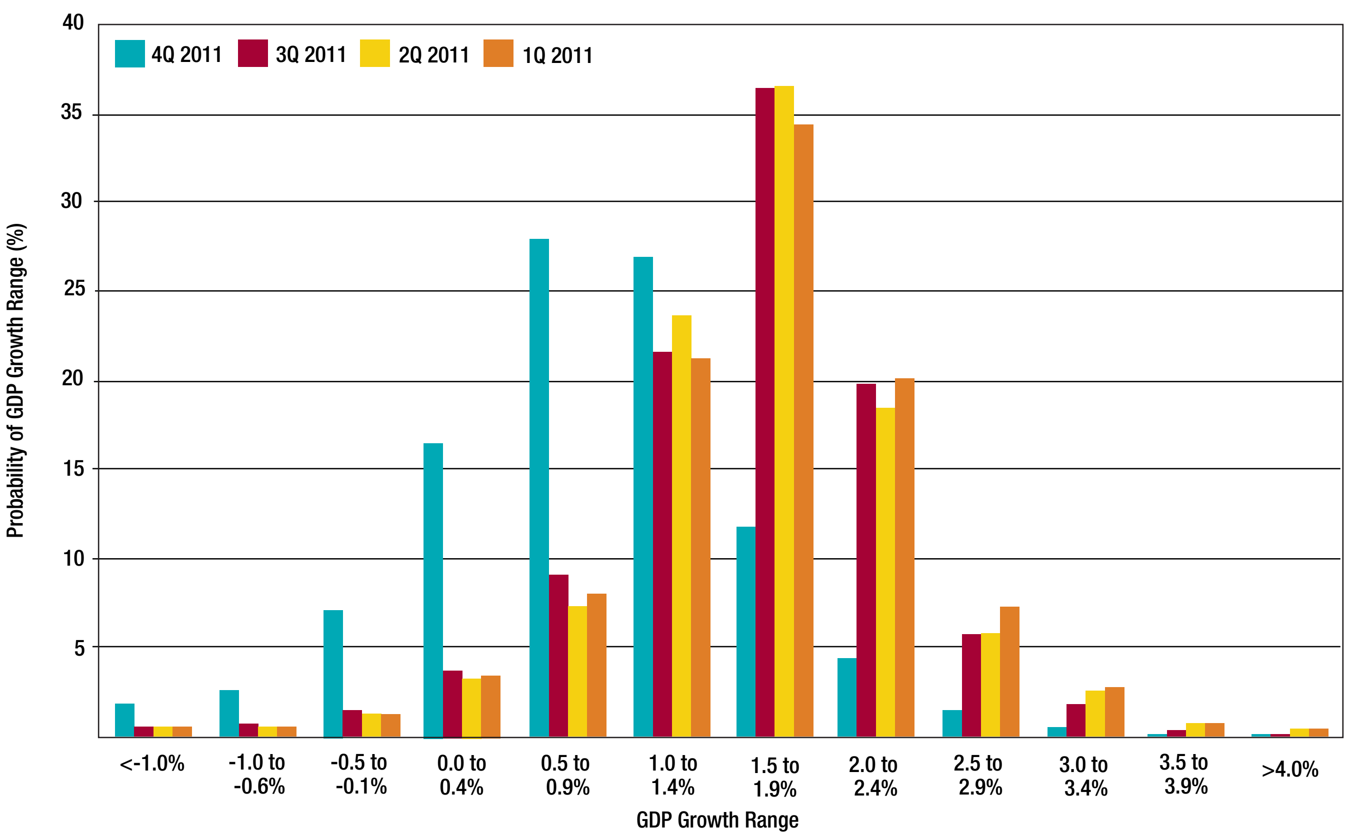
The eurozone financial crisis has worsened since A.M. Best last updated its stress testing in September (*European Investment Stress Test Flags Sovereign Debt Risk*, Sept. 9, 2011). A.M. Best notes that European leaders remain divided over many issues and there is no coordinated effort to solve the current financial crisis. In particular, Germany opposes the application of quantitative easing by the European Central Bank (ECB), which would apply downward pressure on yields, and an increase in the size of the European Financial Stability Facility (EFSF).

At the same time, economic conditions in the eurozone are weakening, which could have a profound impact on the insurance sector. Mario Draghi, head of the ECB, has predicted the eurozone will likely enter a mild recession by the end of this year.

In addition, the results from the most recent quarterly ECB Survey of Professional Forecasters (SPF) indicate that eurozone forecasters have increasingly downgraded their growth expectations for 2012 from forecasts they made earlier in the year. The distribution of forecasts reported in each quarterly survey from the first quarter of 2011 (released Feb. 10) to the fourth quarter of 2011 (released Nov. 10) is shown below. In the first quarter of 2011, the majority of surveyed forecasters were projecting growth in 2012 of 1.0% to 2.4%, whereas the majority of surveyed forecasters in the fourth quarter of 2011 are now projecting growth in 2012 of only zero to 1.4%.

The deterioration of the economic situation is partially attributable to forced austerity measures, combined

Forecasts of 2012 Gross Domestic Product Growth for the Eurozone



Source: ECB's Survey of Professional Forecasters with higher taxes and lower government spending, which has led to a slowdown in economic growth. Other factors in the financial sector are also likely to have a negative economic impact. Namely, banks are attempting to recapitalize by deleveraging and divesting certain assets and businesses that are capital-intensive. They are also underwriting considerably fewer business loans, which will likely restrict the availability of credit.

The Impact of Deteriorating Economic Conditions on Insurers

The recent worsening economic environment and outlook have significant implications for insurers with assets in the eurozone and for those operating within the region.

Moreover, the pressures in the Italian financial markets pose a much greater threat to insurers than the Greek situation. Italy is the third-largest bond issuer in the world; therefore, financial companies, including insurers, have a much larger exposure to the country's sovereign debt.

In September 2011, A.M. Best stress tested the balance sheets of companies against their exposure to eurozone debt and factored in the potential for contagion by applying a haircut to the equities, real estate and corporate bonds held by insurers. Since then, there has been a marked deterioration in the economic situation within the eurozone and a material increase in risk associated with eurozone sovereign debt and financial institutions operating within this region.

As a result, A.M. Best has been evaluating its portfolio of insurers and has based its investment risk sensitivity analysis on third-quarter 2011 financial data, focusing on companies' exposure to eurozone sovereign debt, European banks and debt maturing over the next two years.

A.M. Best is taking a three-pronged approach in light of this analysis:

• Companies with an "outsize exposure" in relation to their risk-adjusted capital as measured by A.M. Best's proprietary capital model – Best's Capital Adequacy Ratio (BCAR) – have been identified. These companies are being brought to the rating committee and are being evaluated for potential rating action. A.M. Best is holding ongoing conversations with these companies and is requesting further information on exposure and mitigating factors such as policyholder participation on life and annuity books of business.

• Companies that do not stand out as having outsize exposure but still could be negatively affected if the situation continues to worsen are being asked to provide additional information.

• Companies that appear to have little exposure to eurozone sovereign debt, European banks and maturing debt will continue to be monitored. For these companies, the evolving economic outlook in the eurozone could negatively affect growth and earnings prospects over the near term.

A.M. Best is currently evaluating companies and their varying degrees of exposure on a case-by-case basis. There is no prescribed rating action that fits all, as each company has its own profile, performance metrics and level of risk-adjusted capital that supports its current ratings.

Insurance organisations with large life and annuity businesses are the most likely to have significant exposure to eurozone sovereign debt, as they maintain very high investment leverage in relation to non-life companies.

An offsetting factor to this greater exposure for life and annuity companies is the potential for policyholder participation in investment losses. However, there are significant negative business implications associated with passing on investment losses to policyholders, and companies would therefore face pressure to absorb these losses on their own accounts. The ability to pass on losses to policyholders also varies by country; for example, regulation in Italy limits insurers' ability to build up surpluses and pass on such losses.

The baseline forecast is for there not to be an Italian default. The eurozone, which will muddle through an extended period of deleveraging, stagnant economic growth and painful austerity measures, is expected to remain intact and work toward a greater fiscal union.

However, the possibilities of an Italian default and/or a country or countries exiting the eurozone are no longer as remote as they once were. Although highly unlikely, a disorderly default of Italian debt would send ripple effects throughout the global financial markets and would very likely send the global economy back into recession.

Other Challenges Facing Insurers

In addition to examining insurers' exposure to investment losses, A.M. Best will continue to monitor rated entities' liquidity and financial flexibility. Discussions will continue as to the management of investment risk, hedging strategies, growth projections and performance expectations in those countries that may face a recessionary environment.

Depressed market conditions would put pressure on growth and earnings in an already competitive market.

An increase in fraud is also expected during difficult economic times.

However, despite the recent natural catastrophe losses and investment write-downs experienced in 2011, the insurance industry remains resilient, with sound levels of capital and good reported earnings.

Beyond the uncertainty as to the near-term performance of the financial markets, the main concern is the absence of a coordinated effort by European leaders to bring a solution to the current crisis.

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