September 9, 2011

European Investment Stress Test Flags Sovereign Debt Risk

Severe market turbulence in July and August of this year has highlighted to European insurers and reinsures the increasingly challenging investment and economic environments in which they maintain critical operations. Slower growth within Europe's major economies has increased the possibility of a double-dip recession and exacerbated the sovereign debt crisis in a number of Eurozone countries – namely Portugal, Italy, Ireland, Greece and Spain.

As a result of these issues, A.M. Best Co. has undertaken a stress test of a representative sample of major European insurers' exposure to sovereign debt and other investment vehicles within Europe. Though A.M. Best does not employ a sovereign ceiling, sovereign debt downgrades are considered when assessing the financial strength of an insurer (see Best's Briefing, *Financial Strength Ratings and Sovereign Credit Risk FAQ*, Feb. 24, 2011). Perhaps even more important, a marked economic decline in these countries has a direct negative effect on insurance companies' business prospects, performance and capitalisation.

A.M. Best performed the stress test using its proprietary capital model, Best's Capital Adequacy Ratio (BCAR), and incorporated a haircut of European sovereign and corporate debt (based on the European Banking Authority stress test guidance issued June 9, 2011) as well as valuation haircuts on equity and real estate investments. The starting point of the test was the respective companies' half-year 2011 results, with the valuation haircuts robust enough to take account of subsequent market falls. The stress test creates a scenario that insurance companies may face if the economic and debt position in the Eurozone were to deteriorate further.

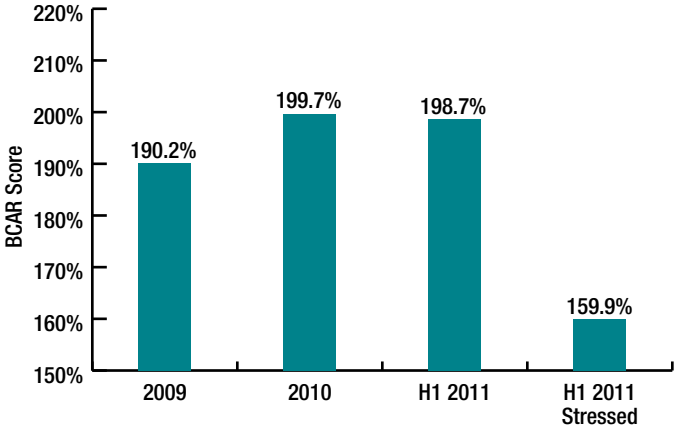
The high-level results of the stress test were as follows:

- The companies with the largest exposures to peripheral European debt were understandably hit hardest by the stress test. Many major European (re)insurers have progressively reduced their exposures to Portugal, Ireland and Greece in the past year so that sovereign debt of these countries only represents approximately 1% of total investments and less than 10% of shareholders' funds of the insurers tested. In isolation, these now reduced exposures did not have a significant impact once stressed, but larger exposures to Italy and Spain resulted in greater falls in risk-adjusted capitalisation. Italian and Spanish sovereign debt represents approximately 7% of total investments and more than 50% of shareholders' funds of these companies, with Italy in particular representing a competitive market among large European (re)insurers.

- Life policyholder participation somewhat mitigated the net impact of the investment losses. Companies with a large proportion of participatory life reserves would be able to reduce the impact on risk-adjusted capitalisation by passing a portion of investment losses to policyholders. Recent write-downs of Greek debt by major insurers have highlighted the difference between the gross loss on the sovereign debt and the net loss recorded through the income statement after policyholder participation and tax. An approximation of the impact of policyholder participation was estimated by A.M. Best across the insurance book, as this information on a country-by-country basis can vary depending on differing scenarios. This does, however, create some uncertainty for insurers from a financial planning perspective on how widespread market losses would affect investment performance.

- Companies with higher asset leverage were more negatively affected by the stress test and experienced greater falls in risk-adjusted capitalisation. A.M. Best's sample of insurers' shareholders' funds represents approximately 12% of invested assets, with asset leverage highly correlated to the level of life business the

European Insurance – Average BCAR Scores (2009-2011) vs. Stress-Tested BCAR (H1 2011)



insurer writes. Companies with higher exposures to equities as a proportion of shareholders' funds also were adversely affected, with recent declines in equity markets expected to hit profitability.

The result of the test was not viewed as a conclusive answer in itself, but rather has prompted further discussions with the individual companies. For example, the test has not been designed to cover every possible investment risk, so specific areas of concern, such as bond and equity exposure to European banks, have been addressed individually with the relevant companies. The BCAR model is one facet of A.M. Best's view of an insurer's overall financial strength, with the company's business profile and financial performance rounding out the analysis. Within the context of the results, A.M. Best will also consider these factors, as well as the company's financial flexibility. Many of the insurers investigated are listed and under normal market conditions have ready access to the capital markets. However, as was seen during the financial crisis of 2008, under extreme negative economic conditions, raising capital can quickly become prohibitively expensive or even impossible if the markets freeze up. It is now difficult to predict how the markets would react to a significant worsening of the Eurozone crisis, but from a credit rating perspective, A.M. Best does not assume low-cost access to the capital markets under such circumstances.

Other factors that serve to mitigate this heightened risk exposure include hedging activities, with some insurers acquiring equity options to hedge tail risk. Exposures to Italy and Spain in particular reflect the fact that insurers match assets and liabilities within different countries in the Eurozone as they are depositing their cash in local investments in support of local business written. These companies will not generally be taking on foreign investment risk in an attempt to increase yield. However, risk-adjusted capital, as measured by the BCAR, has observably reduced for companies with large exposures to these markets, and this cannot be ignored or simply written off as a cost of doing business in these countries.

The recent bond buying programme by the European Central Bank of Spanish and Italian debt has resulted in falling yields, but the situation remains precarious because of the various political factors involved with resolving the crisis. Due to the uncertainty surrounding the situation and its potential resolution, A.M. Best believes that careful monitoring of the exposures of each credit will be important in the coming months. A.M. Best will continue discussions with companies on how they are managing these exposures and what risk mitigation plans they have in place. Companies with an elevated investment risk exposure may come under pressure if the situation deteriorates further. A worsening of the economic or investment landscape in Europe, without mitigating actions taken by company management to offset these heightened risk characteristics, could result in an increase in negative outlooks or downgrades for (re)insurers operating in these markets.

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