



# Financial Crisis – Update on its Impact and What Lies Ahead

November 8, 2010

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Casualty Actuarial Society - Annual Meeting

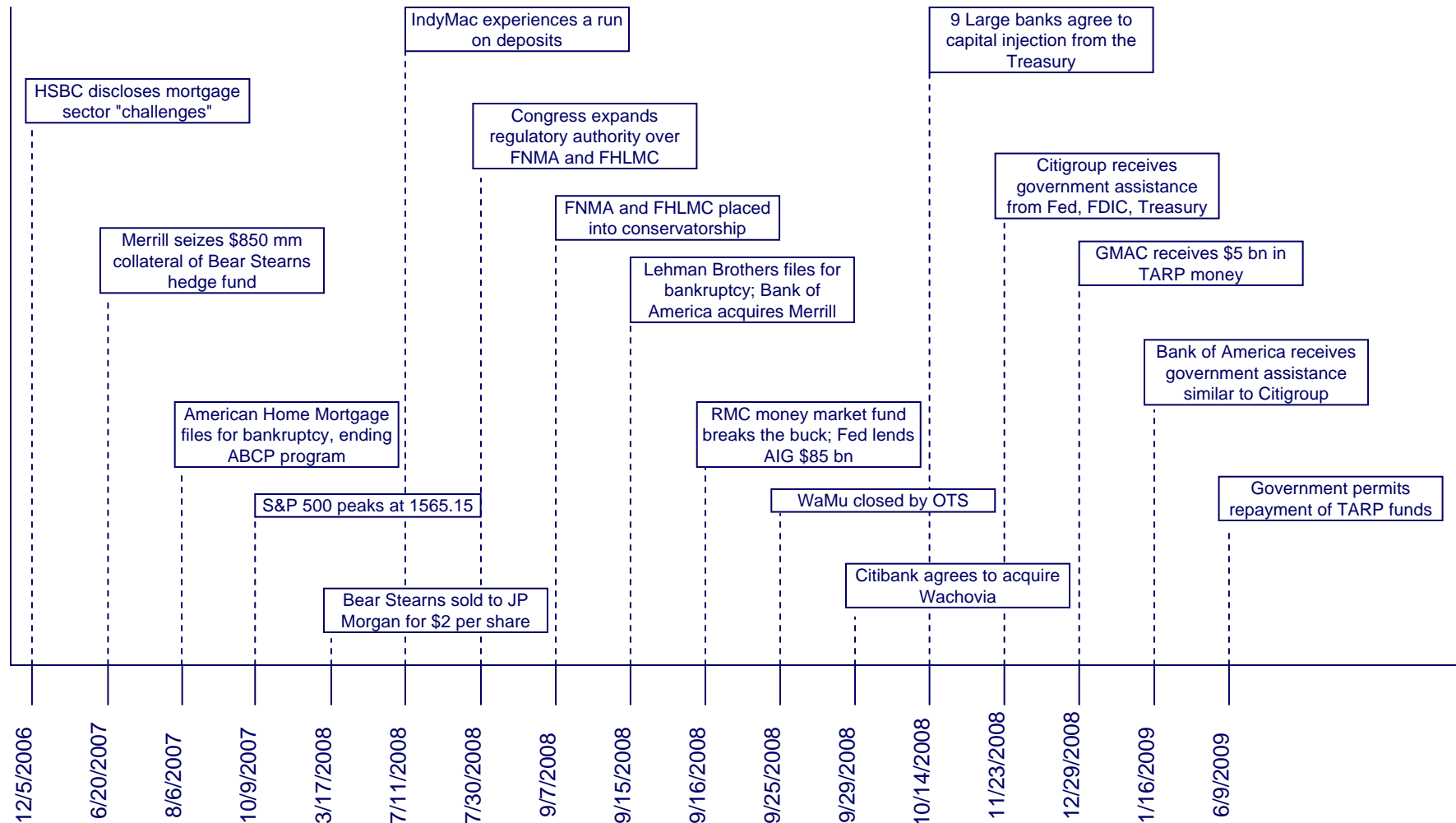


# Overview

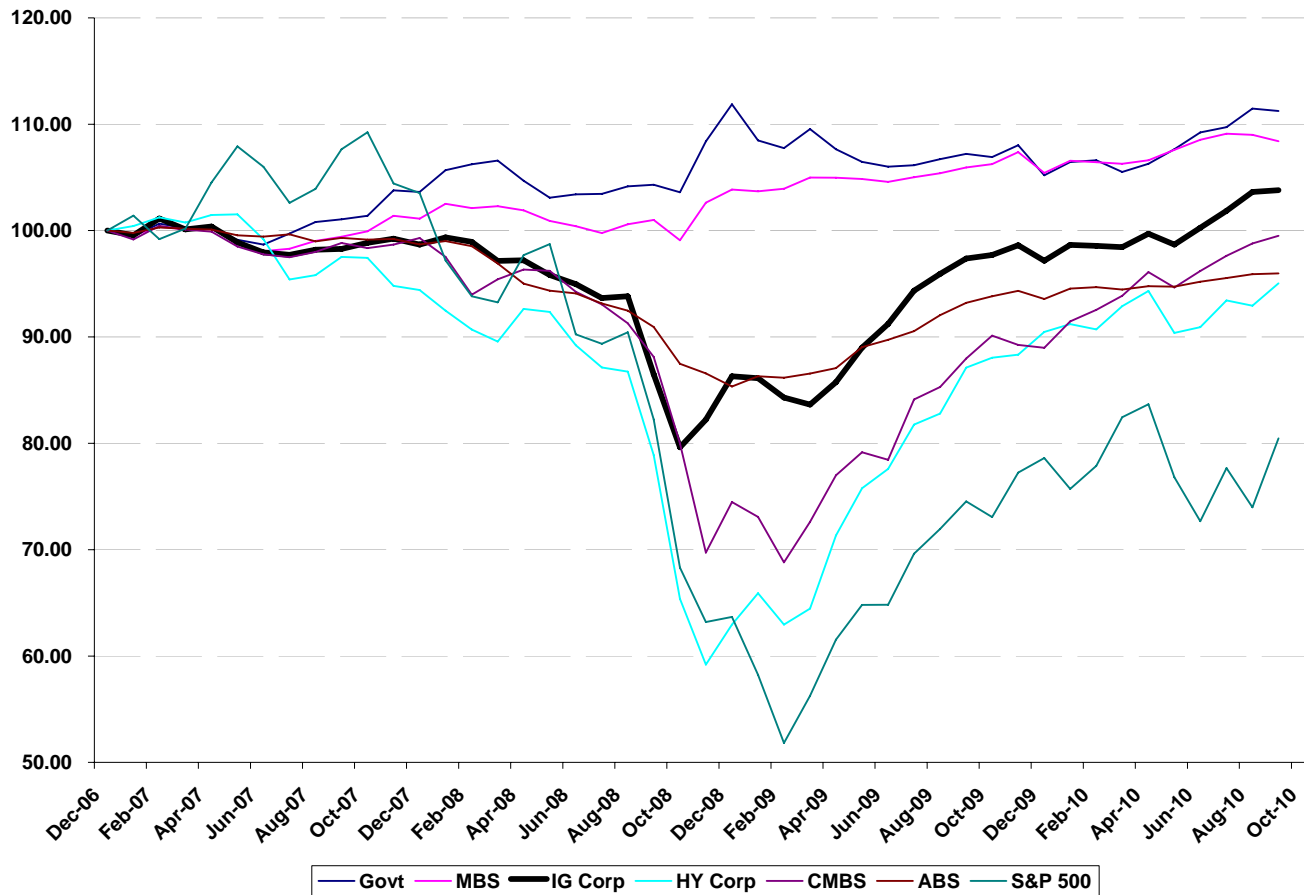


- What happened? The financial crisis of 2008-2009.
- How did the P&C industry manage in the crisis?
- What's next?

# Financial Crisis Timeline – What Just Happened?



# Asset prices through the crisis were extraordinarily volatile.

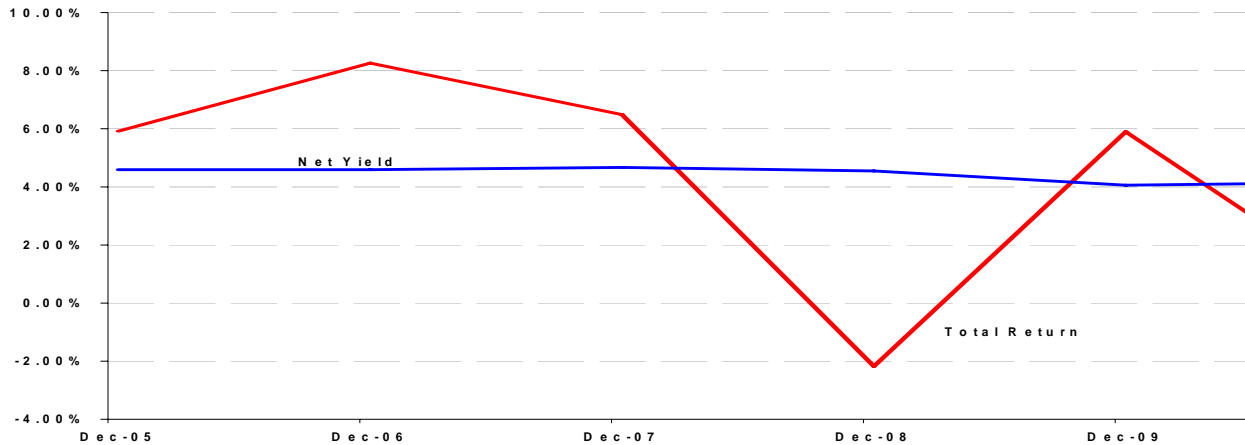


Source: Merrill Lynch, Bloomberg (12/31/06=100)

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# Estimated industry total returns reflected market volatility.



- While less volatile than the worst sectors of the market, P&C companies also experienced negative returns in 2008 and at least partial recovery in 2009.
- In 2010, total returns struggled through Q2 due to the effect of the sovereign debt crisis in Europe on credit spreads and equity markets, but recovered in Q3.
- Net yields have remained stable, but are beginning to trend down as reinvestment rates are very low.

Source: ALIRT  
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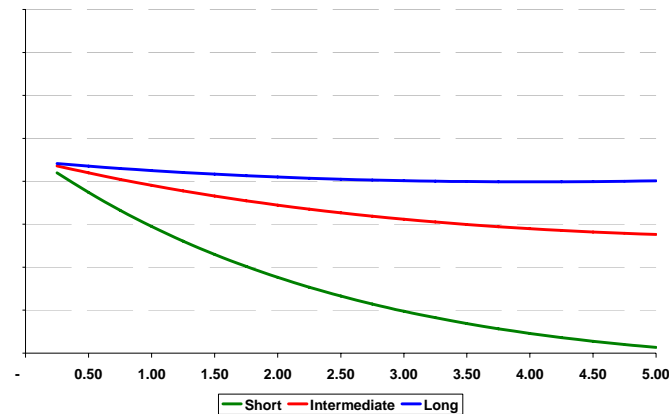
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# The future of investment income for P&C insurers looks bleak.

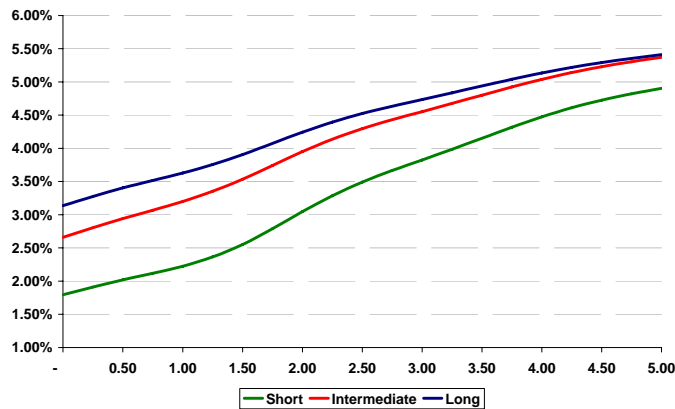


- Low levels of market interest rates will cause investment income to decline.
- The speed of the decline is a function of the duration of the investment portfolio.

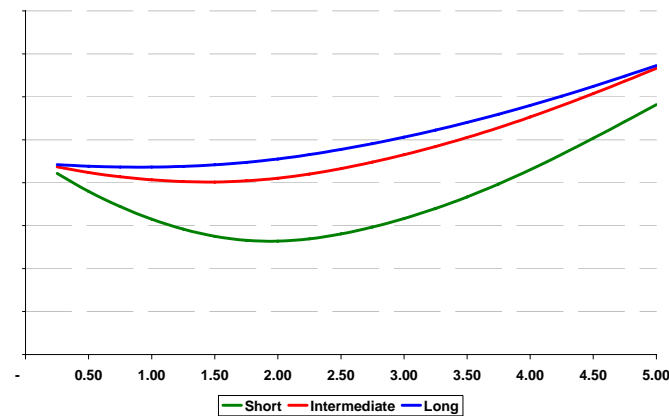
Flat Interest Rate Scenario



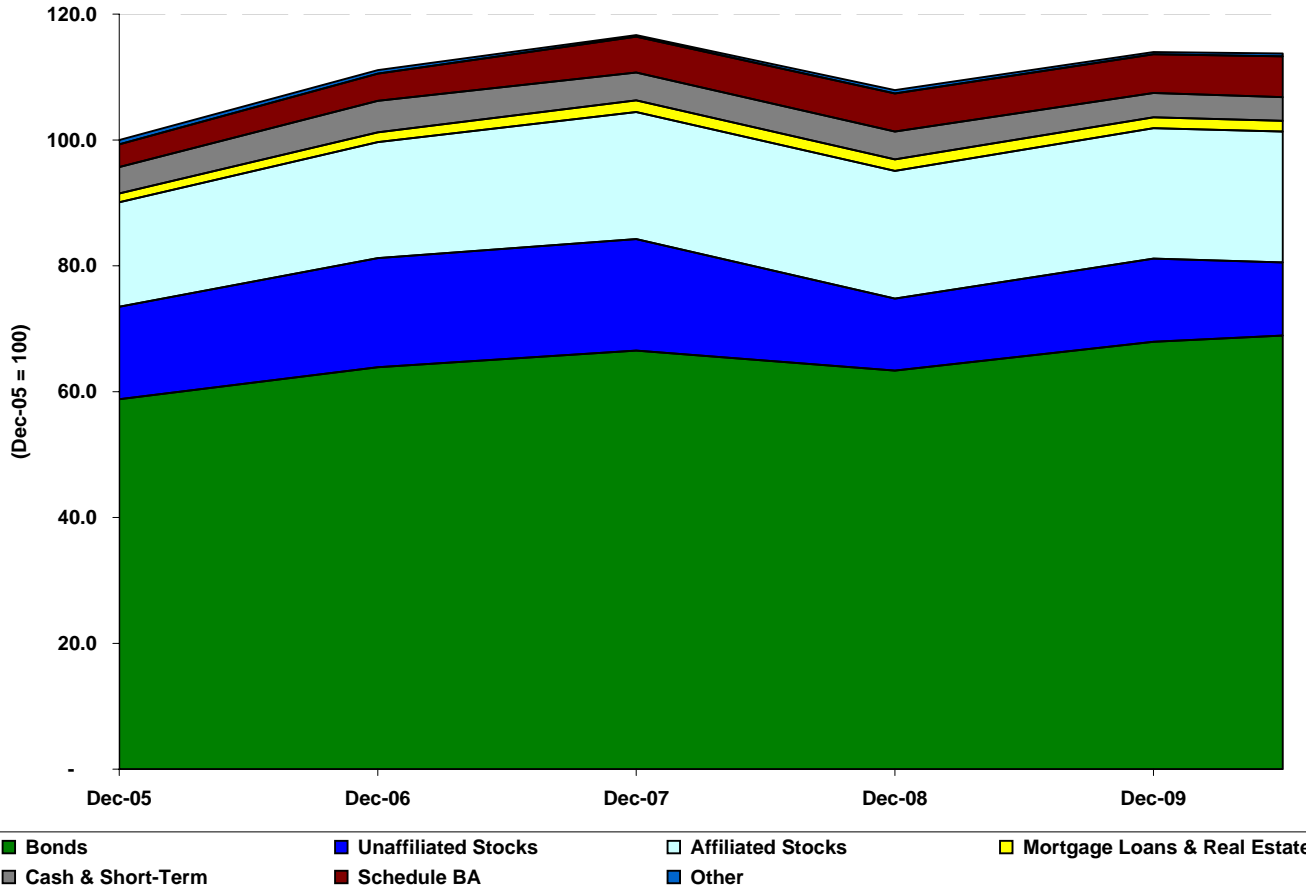
Forward Interest Rates



Forward Interest Rate Scenario



# Asset allocations have become slightly more conservative in the industry.



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# The 2008 decline in equity values and subsequent RMBS and CMBS impairments have prompted changes in RBC.

- Increase Total Available Capital:
  - Deferred tax assets are allowed up to 15% of surplus (from 10%).
  - Structured asset impairments are not to market value, but the discounted value of projected cash flows at the original book yield. (SSAP 43R)
- Reduce Required Capital:
  - RMBS NAIC ratings are a function of statement value, so securities with minor losses (rated around CCC or NAIC 5) can have NAIC ratings in the 1 or 2 range.
  - CMBS will have the same treatment in 2010.
- Is the NAIC too lenient?

Table 1  
Industry Results By Action Level, 2005-2009

	2005	2006	2007	2008	2009
No Action	2,471	2,523	2,567	2,566	2,569
Company Action Level	28	23	22	29	18
Regulatory Action Level	17	15	16	16	10
Authorized Control Level	6	5	8	10	10
Mandatory Control Level	37	33	27	29	28
Total	2559	2599	2640	2650	2635
Percent At 'No Action' Level	96.6%	97.1%	97.2%	96.8%	97.5%

Source: NAIC

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# What's next for real estate?

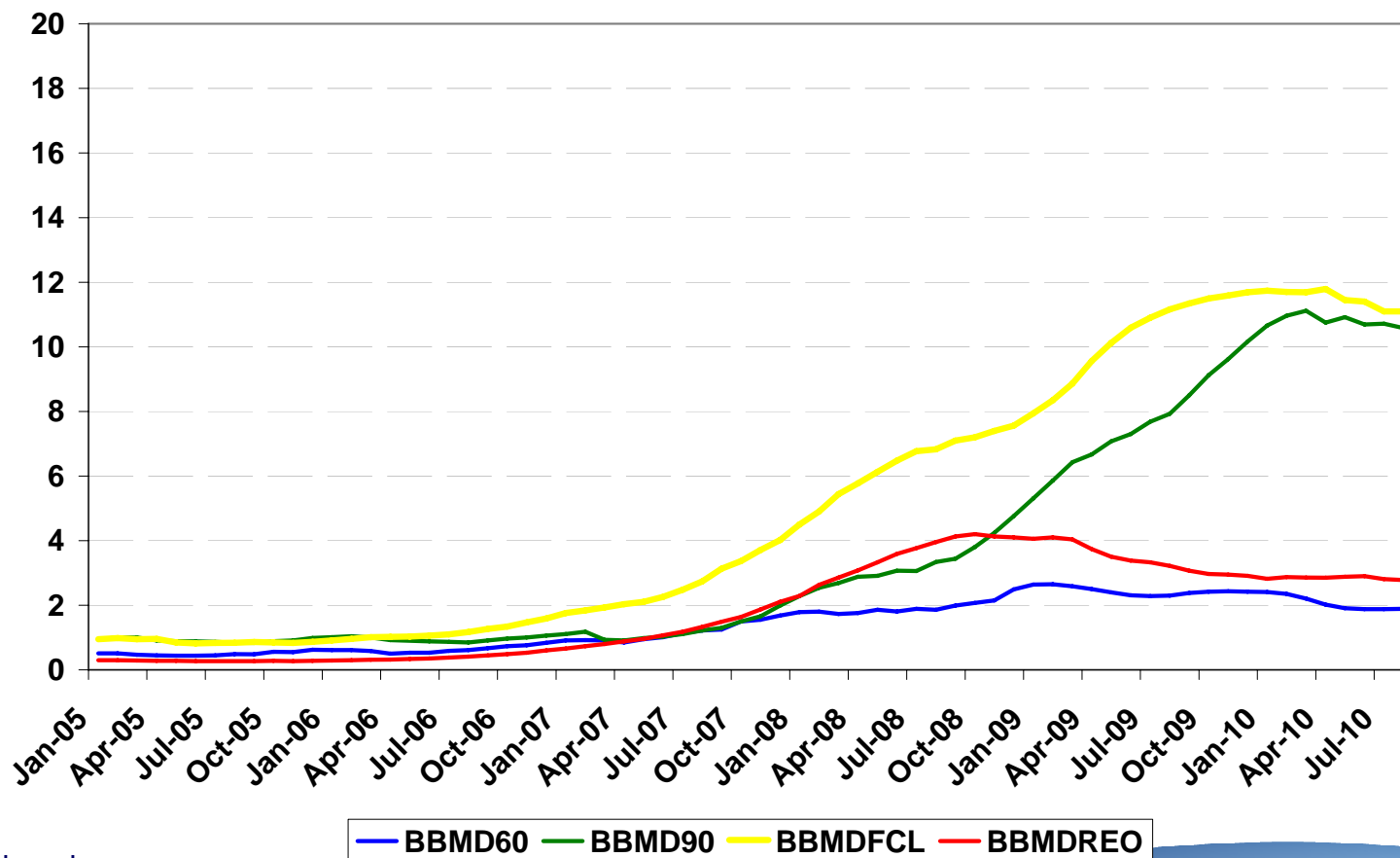


- Commercial real estate workout
  - Workouts invariably require additional capital, and negotiating who will contribute it and how much is time consuming.
  - Servicers have sometimes taken subordinated positions in properties, putting them in a conflicted position when negotiating workouts.
  - The sector will not recover until employment improves and demand for space follows.
- Residential real estate workout
  - Government pressure for modifications delayed many foreclosures.
  - Loan servicers are swamped and issues with robo-signers have caused some foreclosure activity to be suspended.
  - Foreclosure delays generally hurt senior RMBS tranche owners.
  - The sector will not recover until supply is absorbed by the market.

# Residential housing will not recover until supply is absorbed by the market.



## Mortgage Delinquencies



Source: Bloomberg

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# What's next for government policy?



- The financial crisis saw a massive shift of private sector debt to the public sector. Can the public sector support the debt load?
  - Greece – clearly no
  - Portugal, Spain, Ireland and Italy – the jury is out
  - Other developed countries – the problems are yet to come
  - USA – Moody's suggested a downgrade to Aa is possible by 2013.
- The Federal Reserve is considering buying government bonds to stimulate the economy. Will this lead to inflation?
- The challenge for government is to determine how to stimulate growth without spending money.

# What's next for financial regulation?



Dodd-Frank legislation rulemaking summary				
Topic	Rulemaking	One-time reports / studies	Periodic reports	Total
Financial stability	35	8	5	48
Volcker rule	3	1	0	4
Derivatives	56	7	3	66
Investor protection	7	6	2	15
Credit rating agencies	14	6	0	20
Executive compensation	11	1	0	12
Consumer financial protection	29	6	1	36
Mortgage reform	37	9	4	50
Other	93	48	29	170
<b>Total</b>	<b>285</b>	<b>92</b>	<b>44</b>	<b>421</b>

Source: Goldman Sachs  
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# Impact of Dodd Frank (1)



- Derivatives users will be dealing in a different world.
  - Impact on derivatives dealers could reduce their number and increase transaction costs.
  - Centralized reporting and clearing requirements will add administrative burdens, but will also reduce counterparty risk.
- Rating Agencies will be subject to greater oversight.
  - SEC to establish an oversight office and may establish a “Credit Rating Board”
  - Replacing ratings in statutes would be difficult, and is unlikely
- Executive compensation disclosure requirements are increasing.

# Impact of Dodd Frank (2)



- Federal Insurance Office established within Treasury Department
  - Collect data on insurance activities
  - Help identify “systemically important” insurers
  - Report to Congress on modernization of insurance regulation
  - Streamline surplus lines insurance and reinsurance
- “Systemically important” companies will face regulation by the Federal Reserve.
  - Financial Stability Oversight Council identifies
  - FDIC may seize and liquidate
  - What makes a company “potentially systemically important”?
    - Size
    - Interconnectedness
    - Involvement in payment system

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