Economic and Insurance Market Outlook

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Global Economic and Insurance Market Outlook

Thomas Holzheu, Phoenix, May 2012

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The big picture for 2012

- US recovery continues through 2012 is likely to feel "recessionary-like"
  - No political consensus on growth-stimulating measures ahead of the elections.
- The EU debt crisis remains the number one risk for the global economic outlook and will continue to create uncertainty and volatility
  - Euro area in recession until mid-2012, perhaps longer.
  - Growth is hampered by severe fiscal drag and tight credit conditions
- Growth in emerging markets is likely to remain more robust, but has recently been slowing, too.
  - Many developing countries are now loosening monetary policy
- The key risks that could derail global growth are: 1) a policy error in the Euro area 2) oil price shock 3) hard landing in China
- Central banks manage expectations for low interest rates
  - US close to zero through 2014, Europe will lower rates in 2012

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2011 was a year of extreme events

- Highest ever in terms of economic losses (USD 370 bn) and second-highest in terms of insured losses (USD 116 bn)
- Shift in major perils from tropical windstorms to earthquakes, flood, tornadoes
- Several recent events point towards growing exposures of commercial insurance in emerging economies
- Unexpected exposures in a growing, globally-interdependent supply chain
- High frequency of multi-billion dollar catastrophes
- Financial crisis spread into risk-free assets and challenged asset portfolio diversification

→ Need for strong underwriting skills, conservative asset management, low leverage, and successful enterprise risk management.

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P&C market developments

Last year's view	Current view
Record levels of capital	→ Mostly unchanged despite cats
Rates kept falling	→ Rates stable to up
Combined ratios up despite reserves releases	→ Cat losses and more cat losses
Current yields were further down	→ Pressure on yields will continue
Growth accelerated with economic recovery	→ Growth will continue with rates firming gradually
Rebound in ILS, other alternative capital limited	→ ILS well established, shelf sidecars
Low levels of capital raising	→ Alternative forms of capital relief

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Record economic losses in 2011

- Economic losses: USD 370 billion
- Insured losses: USD 116 billion

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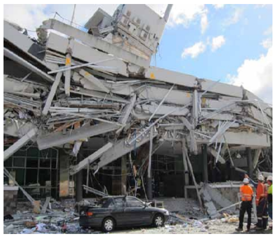
Feb 2011: New Zealand earthquake (Mw 6.3)

- Aftershock of the 4 Sep 2010 earthquake
- 181 fatalities
- Economic loss: USD 15 billion
- Insured loss: USD 12 billion
- New Zealand's most expensive natural disaster
- 2nd most expensive event in 2011
- 3rd most expensive earthquake in history



Source: EERI Special Report Earthquake May 2011

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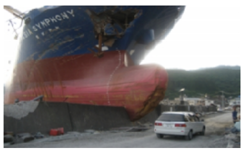
11 March 2011: Japan earthquake and tsunami (Mw 9.0)

- Most powerful earthquake in Japan, 4th strongest worldwide
- >19 000 fatalities
- Economic loss: USD 210 billion +
- Most expensive natural catastrophe in the world (in terms of economic losses)
- Insured loss: USD 35 billion
- Most expensive earthquake in history
- 2nd most expensive event for the insurance industry



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April/May 2011: Tornado outbreaks

- April 2011 (Alabama et al):
  - Insured loss: USD 7.3 billion
  - 4th most expensive event in 2011
  - 10th most expensive US natcat event
- May 2011 (Missouri et al):
  - Insured loss: USD 7 billion
  - 5th most expensive event in 2011
  - 11th most expensive US natcat event
- Deadliest tornado year since 1950
  - 593 fatalities

Source: National Geographic/ Carsten Peter

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August 2011: Hurricane Irene

- First US landfall since Hurricane Ike in 2008
- First hurricane to hit NY city since Hurricane Gloria in 1985
- Insured loss: USD 5.3 billion
- Economic loss: USD 8 billion
- Moderate hurricane losses in 2011
- 3rd most active hurricane season on record

Source: NASA/NOAA GOES Project

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Jul – Nov 2011: Thailand flood

- The country's worst flood in 50 years
- 61 out of 77 provinces affected
- 30 000 km2 were inundated
- Millions of people were affected and more than 800 people died
- Insured loss of 12 billion USD
- Economic loss of 30 billion USD

Largest insured fresh water flood loss in global history

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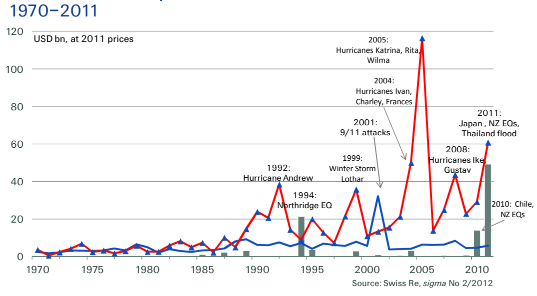
Insured catastrophe losses 1970–2011



Source: Swiss Re, *sigma* No 2/2012

Perception is traditionally dominated by hurricane risk

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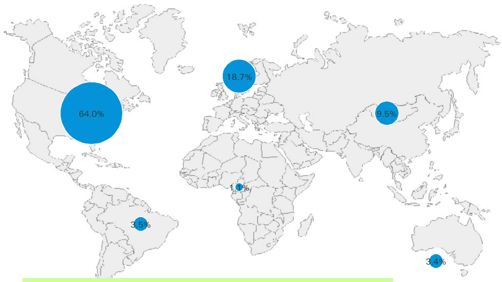
Insured cat losses1980 – 2010
USD 20.7bn average – geographic distribution



▶ Insured cat losses are traditionally determined by North American hurricane losses

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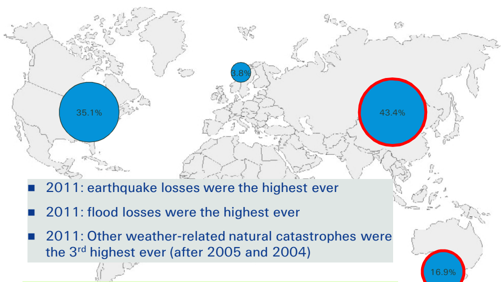
Insured cat losses 2011
USD 116bn – geographic distribution



- 2011: earthquake losses were the highest ever
- 2011: flood losses were the highest ever
- 2011: Other weather-related natural catastrophes were the 3rd highest ever (after 2005 and 2004)

▶ Shift in perils and regions

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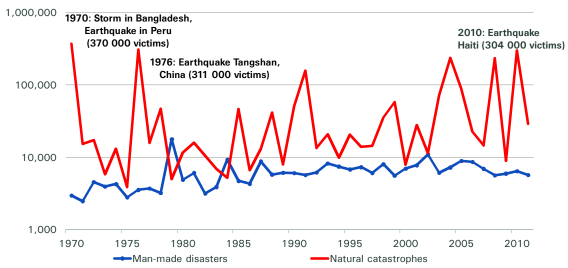
Number of victims 1970–2011:
35 000 victims in 2011



The scale is logarithmic – the number of victims increases tenfold per band

Source: Swiss Re, *sigma* No 2/2012

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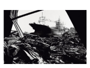
Reinsurers covered large parts of recent cat events

Earthquake Chile, 2010

- 95% of USD 8.5 bn insured loss paid by reinsurers



Earthquake Japan, 2011

- Some 17% of total losses (USD 210bn) were insured
- international re/insurers covered approx. 40%

Earthquake New Zealand, 2011

- 80% of the economic loss of ~ USD 15 bn was insured.
- 73% of the insured losses paid by reinsurers

Floods Thailand, 2011

- 60% of ~USD 10 bn insured losses paid by reinsurers

Source: CEA, Swiss Re Economic Research & Consulting

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Cat losses and market volatility are reflected in 2011 reinsurers' results

- Record losses from cats and poor capital market performance roiled 2011 profitability.
  - Combined Ratio of 109 (96% in 2010)
  - Investment yield down to 3.7% (4.0% in 2010)
- Profitability under severe pressure: ROE of 4% (11% in 2010); ROE in Q2 through Q4 around 10%.
- Top line growth is back; driven by exposure growth and rate increases: NPE growth of 9% (-4% in 2010)
- Capitalization remained strong, average capital growth 2% (3% in 2010) However, assets are inflated considering the low interest rate environment.

➔ Reinsurance industry showed resilience and maintained strong capitalization

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Where do we stand in the Euro area debt crisis?

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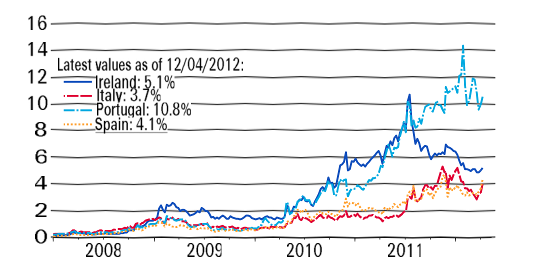
After declining in early 2012, Spanish and Italian sovereign risk spreads have widened again recently

10y government bond yield spreads vs. Germany (% points)



Sources: Datastream, Swiss Re Economic Research & Consulting

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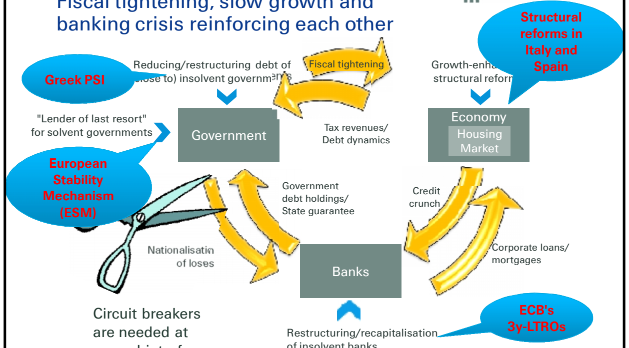
Fiscal tightening, slow growth and banking crisis reinforcing each other



Circuit breakers are needed at several interfaces

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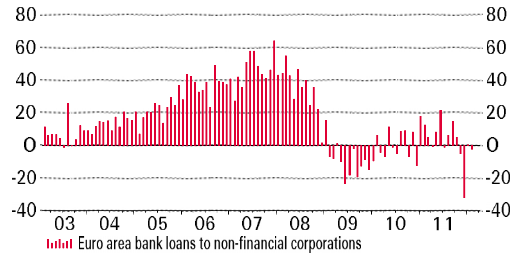
At year-end 2011, the crisis escalated as bank loans collapsed

Euro area bank lending (EUR bn)



Sources: Datastream, Swiss Re Economic Research & Consulting

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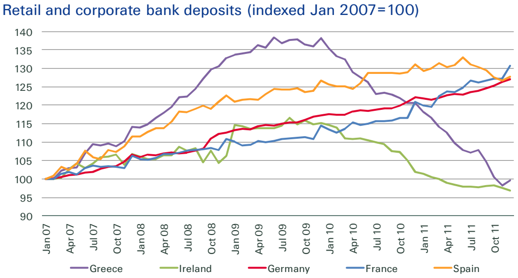
Bank deposit flight in Greece and Ireland

Retail and corporate bank deposits (indexed Jan 2007=100)



Sources: Bloomberg, Swiss Re Economic Research & Consulting

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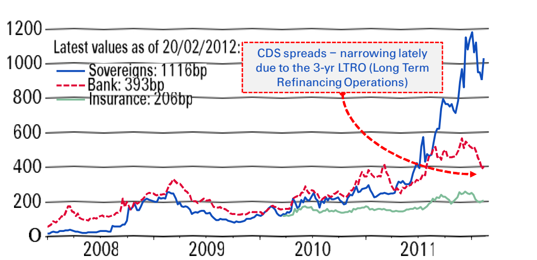
Banks are more affected by the sovereign debt woes in Europe than insurers

European 5 Year Credit Default Swap Spreads, basis points



Source: Economic Research & Consulting, Bloomberg, Datastream

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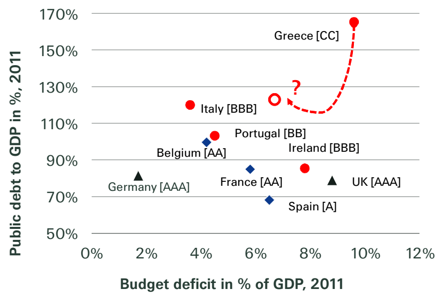
How did we get to the debt crisis?



Sources: ICIA World Factbook, Swiss Re Economic Research & Consulting

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ECB's long-term refinancing operations (3y-LTROs): a partial success

Main goals of 3y-LTROs:

1) Avert liquidity-driven bank failure, given the huge amount of redemptions due in 1H 2012
   - Major funding squeeze of European banks averted ✓
2) Incentivise banks to participate in the "carry trade" of investing cheap ECB funds into higher yielding sovereign debt
   - Funding strains for governments (Italy and Spain in particular) have eased, but banks are no adequate "lender of last resort" (✓)
3) Trigger lending to businesses and households
   - Major credit crunch averted, but banks remain capital-constrained and reluctant to lend freely (✓)

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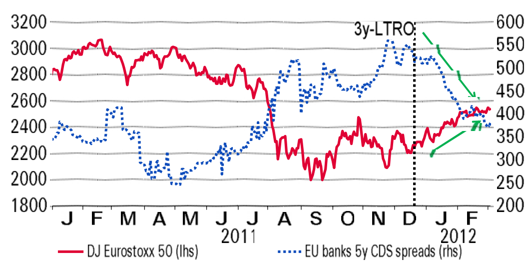
The ECB's liquidity measures had a huge impact on market sentiment

DJ Eurostoxx 50 (index) and EU banks CDS spreads (bp)



Sources: Datastream, Swiss Re Economic Research & Consulting

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What to expect from policymakers in the Euro area?

- No quick and comprehensive solution to the Euro debt crisis.
- The implementation of structural reforms will remain challenging and take years. Nevertheless, there are some encouraging signs that reforms are possible even in a difficult economic environment.
- Policymakers of creditor countries will continue to use market pressure as an instrument to discipline governments with weak public finances.
- Therefore, the impression of "too little, too late" will not go away.
- This implies that financial market volatility is likely to continue and the uncertainty around the Euro area's future to persist.
- The ECB is likely to continue to intervene in sovereign debt markets if necessary to prevent a systemic event (such as a Greek exit).
- **Yields on German and US bonds are likely to remain low for a prolonged period**

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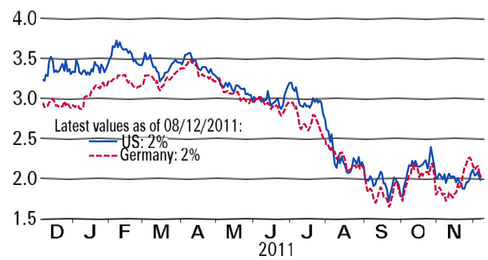
Government bond yields have fallen further due to lower growth expectations

10yr long-term bond yields, one year horizon, daily data



Source: Datastream

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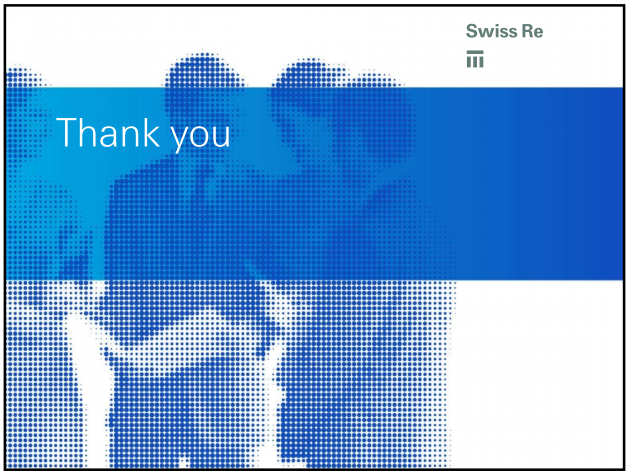
Impact on the insurance industry

- European insurers' capital buffers appear adequate in aggregate to cope with direct losses on their sovereign bond holdings from the smaller peripheral European countries.
- Implications would be much more serious if write-downs on Spanish, and especially Italian bonds, were ultimately required.
- Losses on other asset classes could be more significant e.g. bonds issued by banks, corporate bonds, equities.
- Insurers' investment returns are dependent on bond yields since insurers are large holders of government and corporate bonds.
- US P&C insurers' investments total USD 1.4 trillion of which USD 900 million are fixed income: an interest rate drop of 100 basis points means USD 9 billion lower operating earnings.



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