

AUGUST 2011

Update: Downgrade Implications

Standard & Poor's has downgraded the U.S. sovereign debt rating to AA+ from AAA. Implications for (re)insurers worldwide are mixed. Although there are broad economic implications, markets appear to have anticipated at least some of these, which could forestall rash or catastrophic outcomes. The long-term effects, however, could be profound.

Downgrade and Rating Agency Capital Impact

Despite the approval of a debt-limit compromise in the United States, the U.S. sovereign rating has been downgraded by Standard & Poor's. While (re)insurers and cedents will doubtless be concerned about capital implications, most (re)insurers' risk-adjusted capital will not be impacted significantly. In the Standard & Poor's (S&P) European model, for example, the capital charges are small: from 0.4 percent for securities rated AAA to 0.7 percent for securities rated AA- (with maturities of five years to 10 years). In the Asia-Pacific model, the charges are a bit higher (moving from 0.9 percent to 1.2 percent), but the increase remains quite small.

After a conversation with A.M. Best, Guy Carpenter found that the rating agency does not expect a downgrade to lead to significant increases in rating activity in the property and casualty (P&C) insurance business.

According to the latest A.M. Best Economic Scenario Stress Test, assuming that U.S. debt is further downgraded to AA-, the resulting capital charges would be:

U.S. Government Paper:	0% to 1%
Class 1 Bonds:	1% to 2%
Cash & Equivalents:	0.3% to 1.0%
Equities:	15% to 25%

Approximately 50 companies generated some "red flags" in the A.M. Best scenario analysis. They had BCAR values that declined 50 points or more – or their BCAR values are at or below technical minimums. A.M. Best did not share which of the companies analyzed would be impacted.

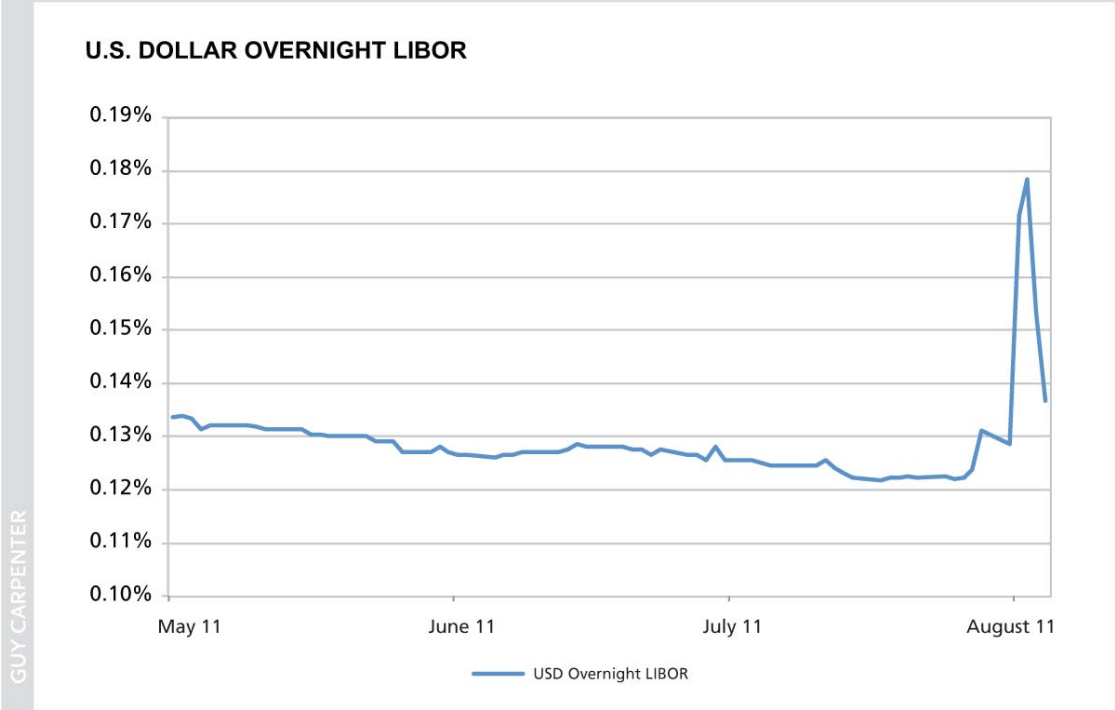
Those companies with relatively high exposures to a U.S. credit downgrade in the A.M. Best analysis are being examined further. Each company's risk management, business profile, liquidity position, earnings capacity and other company-specific characteristics are being assessed to determine whether the exposure will lead to a material impact on financial strength. Additionally, Guy Carpenter's Global Business Intelligence team has screened the Guy Carpenter Global Reinsurance Composite, consisting of 26 markets and client companies to identify potential "red flags," such as significant equity holdings in their

portfolios. The result of this exercise has been largely positive: all carriers in the composite appear to have sufficient cash on hand to pay claims for the next several quarters, and only a very few could conceivably be forced to sell equities within the next two years to pay claims.

Liquidity Impact

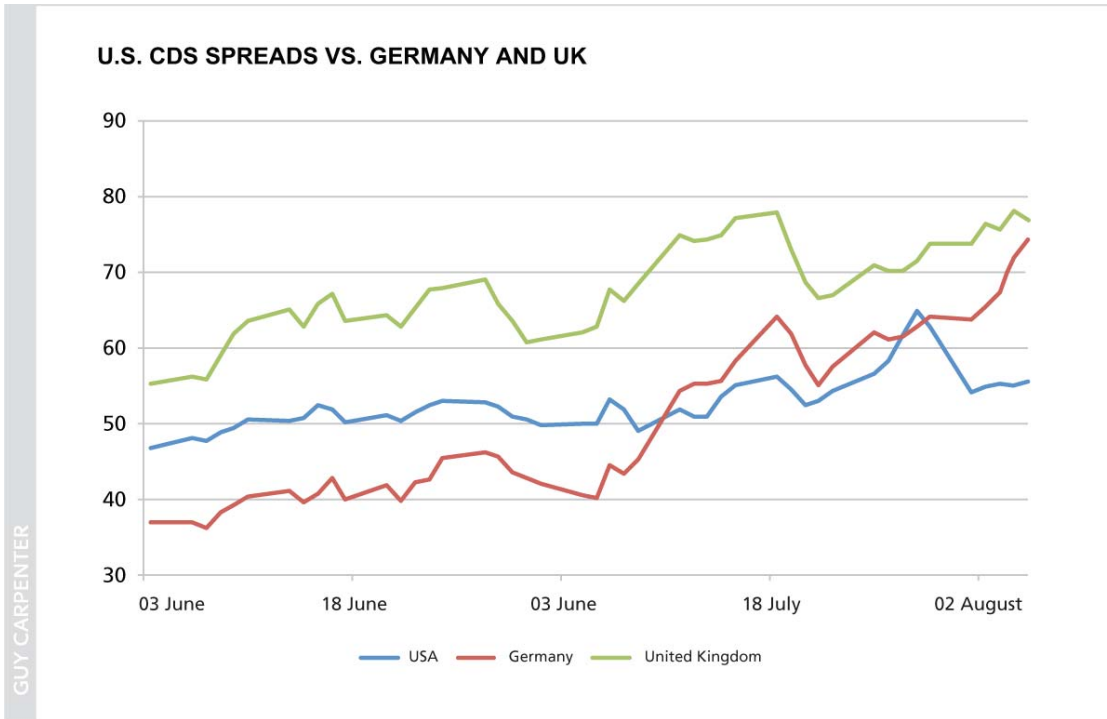
Liquidity is unlikely to be affected significantly. Money and credit markets are still nowhere near the stress levels that were reached during the Lehman Brothers bankruptcy. Interbank lending rates (as measured by the LIBOR-OIS) are expanding at a measured rate. Further, the market appears to have anticipated and discounted a ratings downgrade, already. Indicators of stress in global markets, below, include an increase in overnight LIBOR rates, higher costs to insure against U.S. debt and the decline of the U.S. dollar.

Overnight LIBOR rates are moving higher:



Source: Guy Carpenter, Bloomberg Data

The cost of insuring against U.S. debt has fallen since the vote, but is still elevated:



Source: Guy Carpenter, Bloomberg Data

The U.S. dollar is lower in the intermediate term:



Source: Guy Carpenter, Bloomberg Data

Balance Sheet Impact

Since the end of last year, U.S. Treasury yields have been flat to down, particularly for medium-term securities. This provides some cushion on the Available for Sale values of them relative to year-end reported values. Most U.S. Treasuries are marked to market, which could translate to a low book capital impact should rates rise.

There is some risk that the U.S. downgrade will lead some asset managers to sell riskier investment-grade corporate bonds, for example, those rated BBB, in order to maintain average ratings benchmarks for their entire portfolios. The Moody's Corporate A Index yield currently sits at "normal" long-term levels and is also down slightly from the end of last year. Equity markets, in general, are down approximately 5 percent or more for the quarter, and an improvement in the near term is not likely.

Effect of a Further U.S. Dollar Weakening

Non-U.S. (re)insurers may benefit from the weak U.S. dollar, not to mention further weakening, especially if they have material levels of U.S. liabilities. Also, U.S. companies could become increasingly attractive acquisition targets for non-U.S. carriers interested in both geographic and line-of-business expansion. Non-U.S. buyers would be aided by currency strength relative to the U.S. dollar.

Other Impacts

Risk has increased as U.S. credit quality has deteriorated, which has translated into heightened risk for much of the world's "low risk" fixed-income assets. The (re)insurance industry will face long-term implications if increased risk is paired with leverage maintained at historic levels. The life sector would more likely be impacted than the P&C sector in this scenario.

Among the downstream implications may be the decline of financial institutions' creditworthiness if they are directly linked to the government. A general deterioration of credit quality among all U.S.-domiciled entities – and companies with relatively high exposure to a downgrade – is also a possibility.

Other long-term economic impacts of the U.S. downgrade could include: a potential increase in interest rates, a rise in the equity risk premium (with increased equity volatility and a decline in values) and a drop in real estate values.

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