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Casualty Specialty Update

Inflation: Implications for Long-Tail (Re)insurance

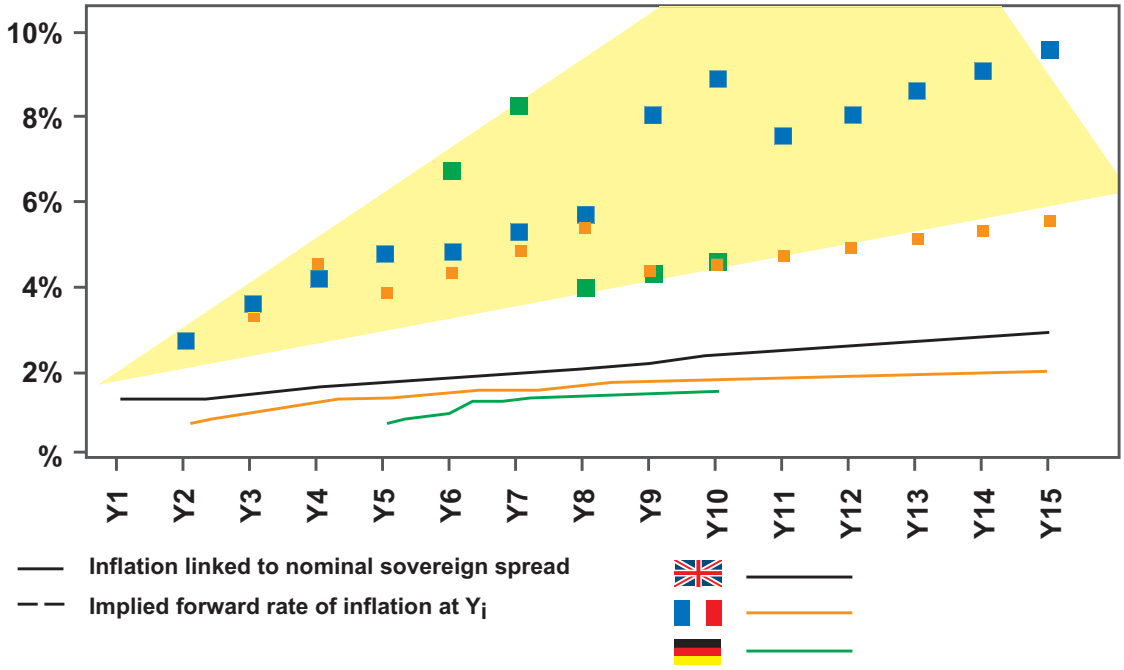
Monetary Inflation

Monetary inflation may not be a concern now, but many worry about the medium-term prospects. In the short run, a worldwide recession and depressed growth levels have kept the risk of inflation contained. But, "quantitative easing" – the pumping of money by governments into the financial system – could set the stage for a spike in inflation a few years from now. These developments could be exacerbated by non-monetary "superimposed" inflationary factors, which could make it more challenging for long-tail (re)insurers to write profitable business.

For many, inflation is not an immediate cause for alarm. In addition to recessionary factors, conservative monetary and fiscal policies in countries such as the United Kingdom, France, and Germany provide for near-term stability. In the future, though, the combination of quantitative easing and other inflationary factors – especially in those Eurozone countries that have weaker economies – will apply upward pressure on interest rates, driving inflation higher.

The current nominal spreads on government bonds compared to inflation-linked government bonds signal the direction of inflation. Current market projections for France, Germany, and the United Kingdom show that a significant increase in all-price inflation is expected within the next five years. The longer-term prognosis for the United Kingdom is particularly concerning, with the spread on inflation-linked-to-nominal UK treasury bonds implying a longer-term rate of inflation above 8 percent.

EU Inflation Expectations



Source: Guy Carpenter and Company, LLC

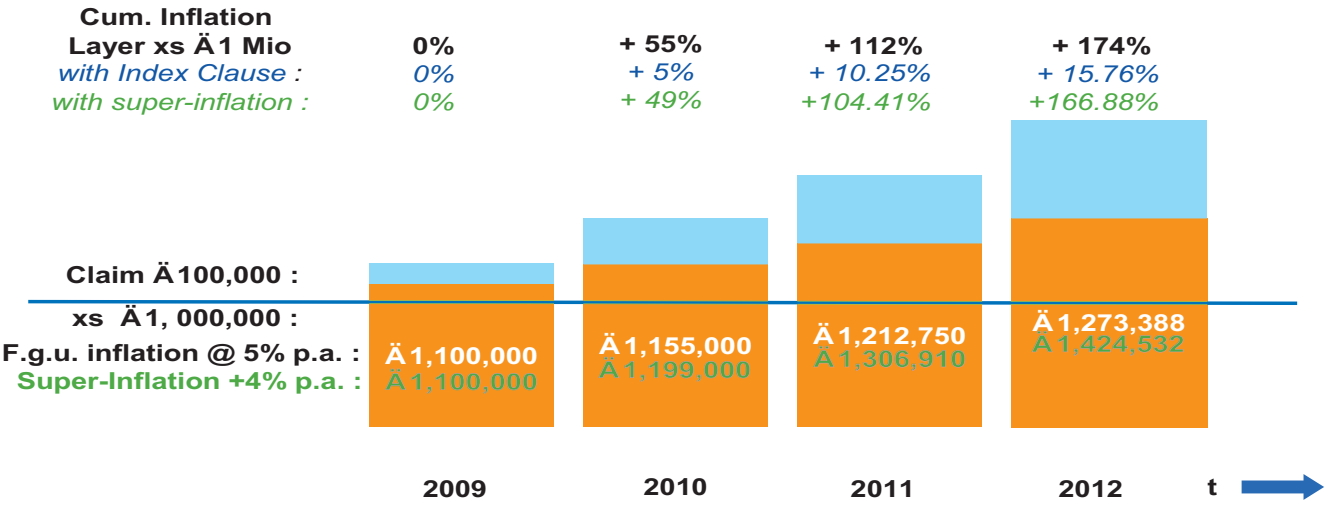
Inflation poses a problem for long-tail insurers and quota share reinsurers – unless they have a sufficient time horizon before claims must be paid. With enough time, carriers can invest the premium they receive and thus counteract the effects of inflation. Typically, (re)insurers opt for low-risk fixed income securities, many of which are pegged to inflation indices. Investment income from both premium and reserves is used to offset the cost of inflation-affected claims.

Excess of loss (XOL) reinsurers also have access to instruments that can mitigate the impact of inflation. The claim payout pattern for XOL reinsurers can allow for several years of investment income on premium and reserves before the cumulative payments reach deductible levels. Index clauses in long-tail XOL reinsurance contracts can provide an additional layer of protection: the deductible is adjusted upward based on an index reflecting normal monetary inflation (e.g., retail prices or average wages and salaries) in the country where the loss occurs.

The effect of monetary inflation on lump sum payments used to generate annuities can be very different. A low rate of monetary inflation and interest rates will generate a low discount rate. The lower the net present value discount, the higher will be the lump sum payment.

Other Forms of Inflation

While most people look for inflation in retail prices or average wages and salaries, it can be hidden in many other economic measures, as well. In fact, the other factors can have a disproportionate impact on XOL (re)insurers. These forms of "superimposed" inflation include: legal, social, medical cost, and "emerging risk" inflation.



Source: Guy Carpenter & Company, LLC

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Legal Inflation
Legislative influences can change standard inflationary factors completely. The enactment of the 2007 EU Fifth Motor Insurance Directive, which imposed new minimum third-party bodily injury limits of EUR1 million per person or EUR5 million per event, may have had little or no impact in advanced jurisdictions (such as Germany) where victims already enjoy compensation limits well above the EU minimums. In less developed EU territories (e.g., Greece), the directive has led to a leap in bodily injury indemnity limits far beyond the rate of monetary inflation.

Yet, sometimes the effect of legal inflation is more subtle: a victim may successfully obtain recompense for physical or emotional trauma, or a court of appeal may uphold a new head of damage or a new way of quantifying it. Legislation may encourage judges to devise new types of awards, as is the case with the UK Courts Act 2003, which allows damages for future pecuniary loss in bodily injury cases to be compensated by a Periodic Payment Order (PPO). This has resulted in a substantial new Incurred But Not Enough Reported (IBNER) exposure in the settlement tail for (re)insurers. In France, the provisions of the law 2006-1640 of December 21, 2006 have redefined and increased the injured party's rights to a full range of third-party care, leading to a massive increase in the cost of bodily injury settlements. Both the UK and French changes in law apply retroactively to any open claim; the effect of such a paradigm shift is therefore multiplicative, applying across several accident years.

New legislation, such as the EU Erika III ship-owners' liability package and the EU Environmental Damage Liability Directive are empowering non-governmental organizations and interest groups to assert a general public right to compensation for loss of amenity. This opens new areas of exposure beyond the scope of normal civil legal liability and creates an entirely new set of claims.

Social Inflation
Social inflation is driven by changing social attitudes and by demographic and political developments. Through global news media and the internet, individuals have become more aware of their rights. As living standards improve, peoples' quality of life expectations have increased, making it more expensive to restore a victim to his state immediately prior to the loss occurrence.

Insurers have long expected to adjust pricing and reserving in line with changing mortality tables. But economic difficulties combined with an aging population mean that governments across Europe are less able to fund pensions and long-term medical care. Consequently, governments are looking to shift the burden from state healthcare providers to the private insurance industry. An example of this pattern can be observed in the case of the VIOXX pharmaceutical product liability series loss in Germany. The healthcare funds (*Krankenkassen*) are proving to be more aggressive than in the past in pursuing recourse against the manufacturer and its product liability insurers.

Medical Costs Inflation
A subject of much debate has been the increasing divergence between standard monetary inflation and the rate of medical care costs inflation. According to the *Comité Européen des Assurances* (CEA), medical care costs in Europe from 1996 to 2005 inflated at approximately twice the rate of the all-items price index.

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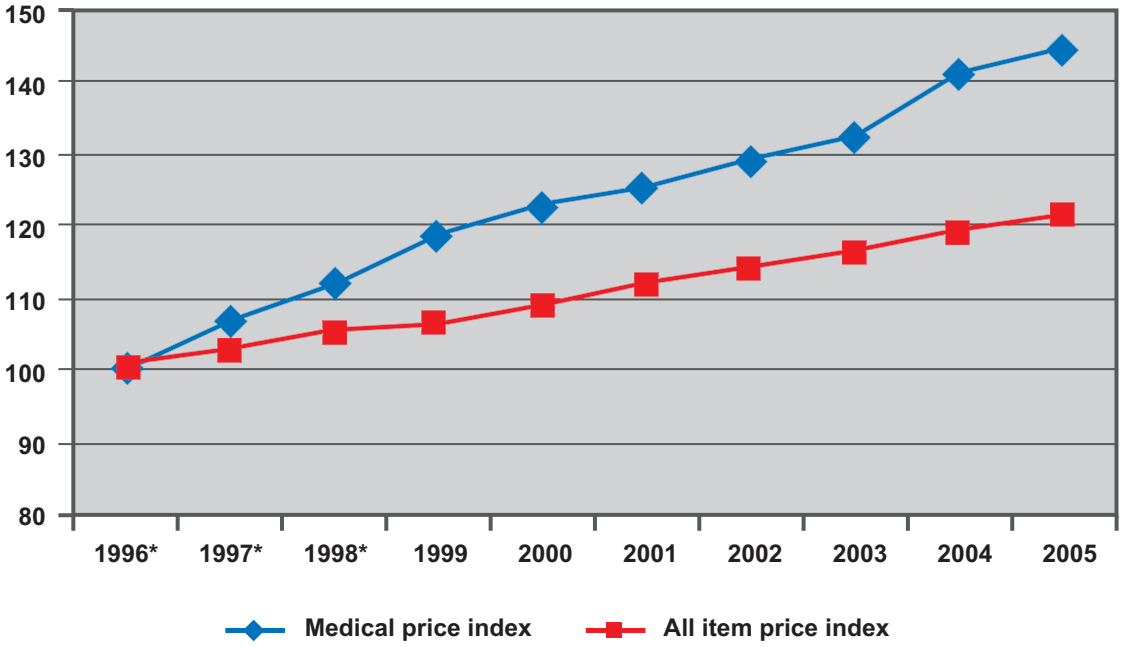
Medical Price Index vs. All-Item Price Index



*** Estimates**

Source: Comité Européen des Assurances

Emerging Risk Inflation

(Re)insurers writing long-tail liability risks today cannot project future developments with any degree of certainty. Technological developments may change the nature of liability claims completely and lead to new injuries and diseases (e.g., will nanotechnology lead to the "new asbestos"?). On the other hand, however, they could enhance the ability of victims to avoid injury or to recover from those diseases.

Conclusion

An increase in interest rates over the next few years is quite likely to result in monetary inflation, which in itself could impair the ability of (re)insurers to pay claims. But, super-inflationary factors may not continue to grow at the same pace. The effect of increased monetary inflation, therefore, may be to narrow the divergence between the base indices typically used in XOL reinsurance contracts and the more specific cost of care indices which some reinsurers currently argue should replace them. In the longer term, a standard monetary inflation base index may not prove to be so wrong after all.

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The Credit Crunch and Reinsurance

When problems in the subprime mortgage market erupted into a full financial catastrophe last year, conventional wisdom suggested that property and casualty (P&C) insurance companies would suffer. The culprit, many believed, would not be investments in mortgage-backed securities (MBS) like the life insurers. Rather, it would be the possibility of slipped bond ratings because of problems with bond insurers, ultimately lowering the value of the bonds held in P&C investment portfolios. The increase in insured losses as a direct result of subprime and the ensuing credit crunch would certainly drive P&C companies to have poor returns, the thinking continued. Even at the mid-point of 2008, talk of a turn in the market began to percolate.

Today, however, we can see that the worst-case scenarios imagined in 2008 did not transpire. (Re)insurers did lose a considerable amount of capital – 18 percent to 20 percent, as measured by the Guy Carpenter Global Reinsurance Composite – but, aside from a few casualties, the stability of the industry was never truly threatened.

We've seen double digit rate increases in Financial Institution (FI), Professional Indemnity (PI), Directors & Officers (D&O), Surety/Trade Credit, and Political Risk, but rates have remained relatively stable in other lines of business. The rate increases occurred mainly because of poor loss experiences in specific lines, though a reinsurance capacity crunch may also be a contributing factor.

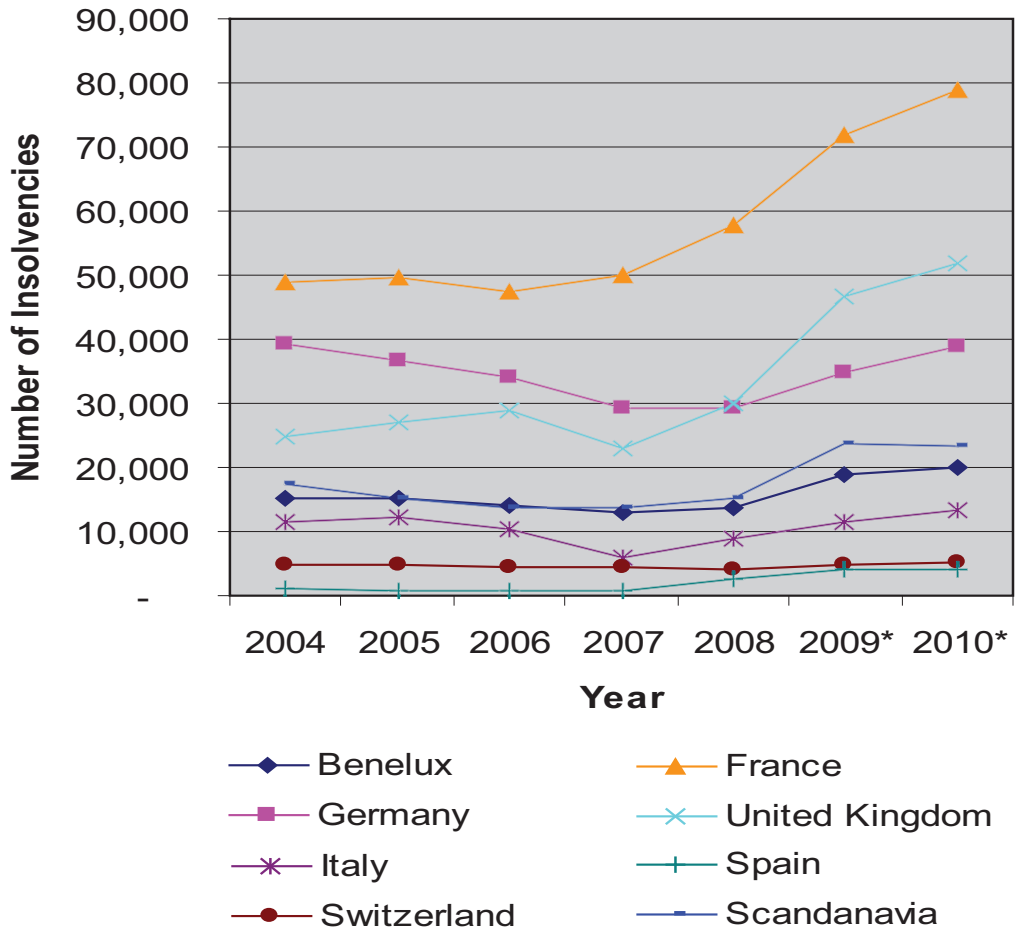
In Europe, we've seen several major reinsurers withdraw or cut back significantly on financial lines (D&O and PI) liability treaties. The timing of this is surprising in some cases, as most of these treaties are on a risks-attaching basis – i.e., these reinsurers are left with paying the claims of 2007 and 2008 but receiving none of the upside of rate increases and tightening of terms seen in this year (and probably in 2010). Granted, most of the relationships abandoned had been long-standing, and reinsurers and insurers alike had benefited from years of profitable results. Nonetheless, the withdrawal of these major reinsurers has had an impact on the amount of capacity available. This "reinsurance capacity crunch" has led to insurers finding themselves with larger net retained lines which, in turn, should result in smaller overall lines offered by insurers on given risks compared to recent years.

Countering this "downsizing" is the emergence of new carriers looking to take advantage of the anticipated sellers' market. Underwriters from established market leaders who have been weakened financially due to their involvement with mortgage-backed securities, have sought greener pastures and are now employed by these new carriers. Once again, the reinsurance capacity crunch has kept available line sizes in check. However, the emergence of these new markets may also be slowing the market's turn through the simple economic principle of supply and demand.

The lack of claims outside FI and Trade lines has delayed a substantial increase in pricing for European carriers. Average incurred loss ratios for Commercial D&O, Commercial PI, and General Liability (GL) has been far below expectations in Europe since 2002. But, will this trend of relatively benign claims activity in these lines of business continue?

Some economic indicators seem to point toward an increase in claims frequency. Foremost among these are the increase in expected corporate insolvencies. Traditionally, insolvencies have driven D&O claims. So the indication is that the insurance industry should experience an increase in D&O claims in 2009 and 2010. Additionally, we expect that many of these insolvencies would be in the small-to-medium-sized enterprises segment of the business, which has historically been profitable. On the PI side, advisors are often brought into lawsuits when the companies they were advising become insolvent.

European Corporate Insolvencies



Source: National statistics, calculations by EulerHermes as of May 2009
Note: Margin of error due to differing statistical methods

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Insolvencies are just one economic indicator that more claims are on the horizon. It is commonly thought that people are more likely to sue in poor economic times. As unemployment rates rise, people may try to use recent changes in employment law to sue their former employers for wrongful termination. In certain situations, indemnity may not result from the claims, but significant legal expenses will still need to be paid.

Reinsurers have cited the potential for increased claims notices given the economic climate during the 2009 renewals, and concerns have arisen for January 1, 2010, as well. Pushes for significant rate increases and tighter terms have been delayed, though, as profitability in recent years and a clear lack of claims activity made it difficult for reinsurers to justify what they sought. As we approach the next renewal, both insurers and reinsurers are wondering if the claims lag has finally caught up. If so, the reinsurers will want their due.

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