The Fiscal Compact, the Economic Environment & Solvency II: Possible Implications for Life and General Insurance Companies

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Plan of Presentation

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Fiscal Compact

Andrew Caslin

Fiscal Compact
Brief Summary ‘Article 3(2)’

- Key rules to be enshrined in national law
  - ‘Balanced budget’
  - Ensure rapid convergence towards the balanced budget
  - Automatic correction mechanism with an obligation to implement measures to correct deficit
  - Independent body at national level to monitor observance of the rules
- Fail to comply with Article 3(2)
  - Matter *will* be brought to the Court of Justice of the European Union
- The ‘carrot’ for ratification:
  - Access to funding from the EU’s new permanent bailout fund – the European Stability Mechanism (ESM)

Fiscal Compact
Brief Summary ‘Balanced Budget’

- Structural deficit: General government deficit adjusted for slow/fast growth & once-off items
- Current EU Rule: Limit annual, general government deficit to 3.0% of GDP
  - Fiscal Compact: ‘Balanced budget’ mean limit structural deficit to 0.5% of GDP
    - Rule to be put into national law together with an automatic-corrective-action trigger
    - Country-specific target agreed with EU

Fiscal Compact
2011 EU Government Deficits

- Largest EU government deficits as a percentage of GDP:
  - Ireland (-13.1%) *or (-9.4%)?*
  - Greece (-9.1%);
  - Spain (-8.5%);
  - United Kingdom (-8.3%);
  - Slovakia (-6.4%);
  - Cyprus (-6.3%);
  - Lithuania (-5.5%);
  - France (-5.5%)
- France and Spain are respectively the 2nd and 5th largest economies in the Eurozone

Source: Eurostat

Fiscal Compact
Move to Balanced Budget

- Ratio: (General Government Deficit)/ GDP
- Balancing the budget
  - Growth in GDP
  - Increase in taxation
  - Reduction in general government spending
  - Combination of these items

Fiscal Compact
Move to Balanced Budget

- Article 3(1) of the Fiscal Compact
  - Contracting Parties shall ensure rapid convergence towards their respective medium-term objective

- Impact of synchronised implementation of the balanced budget rule?
  - France and Spain alone two of the largest economies in the Eurozone

Fiscal Compact
Brief Summary 'Debt-to-GDP' Ratio

- Current EU Rule: Limit the general government debt-to-GDP ratio to 60%
  - Excess debt must be reduced by 1/20th a year on average until the target is met
  - Fiscal Compact: Restates this rule

Fiscal Compact
Government Debt-to-GDP Ratio

- EU countries with highest Government Debt-to-GDP ratios
  - Greece (165.3%), Italy (120.1%), Ireland (108.2%)
  - Portugal (107.8%), Belgium (98.0%), France (85.8%)
  - United Kingdom (85.7%), Germany (81.2%)
  - Hungary (80.6%), Austria (72.2%), Malta (72.0%)
  - Cyprus (71.6%), Spain (68.5%) and the Netherlands (65.2%)

Source: Eurostat

- All have Debt-to-GDP ratios in excess of the 60% limit

- Germany, France and Italy are the first, second and third largest economies of Europe respectively

Fiscal Compact
Move to Balanced Budget

- Reducing the debt-to-GDP ratio
  - Growth in GDP, increase in taxation, reduce general government spending or a combination of these items

- Impact of synchronised reduction in debt-to-GDP ratio?
  - Germany, France and Italy are the first, second and third largest economies of Europe respectively
  - Apply 1/20th per year rule to these countries
    - Germany must cut debt-to-GDP ratio by ~1.1% p.a.
    - France must cut debt-to-GDP ratio by ~ 1.3% p.a.
    - Italy must cut debt-to-GDP ratio by ~ 3.0% p.a.

Fiscal Compact
Impact & Wriggle Room?

- Impact on the European economy of implementing similar policies simultaneously across signatory countries
  - Balanced budget rule & debt-to-GDP ratio rule
  - Highly deflationary if governments cut expenditure and raise taxes to meet Fiscal Compact

- Wriggle room?
  - To prevent similar, simultaneous deflationary policies across the EU

Fiscal Compact
Wriggle Room

- Time frame for ‘balanced budget’ will be proposed by the Commission
  - Taking into consideration country-specific sustainability risks
    - Some hope for avoiding synchronised simultaneous implementation

Fiscal Compact
Wriggle Room

- Signature countries may deviate from targets in case of *‘exceptional circumstances’*
  - The concept of *‘exceptional circumstances’* is widely defined
    - Encompassing once-off events and prolonged periods of economic hardship
  - Immediate implementation of debt reduction rules likely to be waived for the foreseeable future

Fiscal Compact
Politics

- Likely to be accepted by voters
  - Implied probability of a 'YES' vote ~ 87%
    - Source: Paddy Power, the largest bookmaker in Europe

- It is designed to reassure the German electorate that loans by Germany to 'periphery' Member States will be repaid
  - Sound management of their public finances enshrined in domestic law
  - They submit the European Court of Justice for breach of those laws

- Fiscal Compact adopted by Eurozone Member States
  - German politicians may be able to persuade their electorate
    - Permit the issuing of EUR-denominated bonds guaranteed collectively the Eurozone Member States
    - Provide further capital to the European monetary fund

Economic Environment

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Economic Environment

- Ireland's total debt: Household, non-financial corporations, financial institutions and government debt
  - 663% of GDP at the end of Q2 2011
  - Highest total debt of Eurozone crisis countries: Greece (267%), Italy (314%), Portugal (356%) and Spain (363%)
  - The average 'total debt to GDP' for mature economies is 339%
- Breaking down Ireland's total debt figure:
  - Households made up 124% (77%) of GDP
  - Non-financial corporations 194% (82%) of GDP
  - Financial institutions 259% (80%) of GDP
  - Government debt 85% (100%) of GDP
    - Figures in brackets corresponding average of mature economies

Source: McKinsey & Company

Economic Environment

- Majority of consumers and companies in the private sector are ‘saving’
  - Repaying loans in order to reduce their debt burden
- Irish Times (3/3/12): An estimated 40% of mortgaged homeowners in Ireland are in negative equity
  - Property asset values below outstanding loans
    - Dublin residential property prices are 57% below the February 2007 peak (Source: CSO)

Economic Environment

- Such consumers and companies are unlikely to wish to borrow further
  - There are unlikely to be many willing to lend to them
  - Paying down their debt ***despite*** near-zero interest rates
- 3 months to the end of March 2012 (Source: Central Bank)
  - Net monthly flow of loans to households averaged *minus* EUR404m
  - Net monthly flow of loans to non-financial corporations averaged *minus* EUR227m

Economic Environment

- Y = C + I + G + (X – M)
  - Remember this equation?
- Few consumers and companies interested in borrowing
- Reduction in consumption expenditure and investment expenditure in the economy
  - Ireland: Personal spending on goods and services has fallen in 2008, 2009, 2010 and 2011 & looks set to fall again in 2012
- Government is not spending
- A massive increase in net exports needed to keep the economy growing
  - Growth helps all the Fiscal Compact ratios

Contraction in Bank Lending

- Bank lending to consumers and companies that wish to borrow for consumption or investment purposes constrained by:
  - De-leveraging by many banks in the Eurozone including Ireland
  - European Banking Authority's more stringent capital requirements for certain banks

Contraction in Bank Lending

A bank's core Tier 1 ratio is calculated as follows:

$$\text{Core Tier 1 Ratio} = \frac{\text{Core Tier 1 Capital}}{\text{Credit Risk Weighted Assets} + \text{Operational Risk Weighted Assets} + \text{Market Risk Weighted Assets}}$$

Source: Barclays Capital

Credit Risk Weighted Assets, in simple terms, loans made by banks, account for well over 80% of all risk weighted assets.

Contraction in Bank Lending

- Bank of International Settlements proposes (Basel III) that banks reach a core Tier 1 capital ratio of 7% by 2019
  - A 7% core Tier 1 capital requirement is quite demanding especially in the light of the systemic banking crisis facing EU banks
- Pushing the time to qualify out to 2019 gives a reasonable prospect of the new 7% core Tier 1 capital requirement being met
- EU summit in Brussels on 26 October 2011
  - Certain EU banks were required to raise their Core Tier 1 capital ratio ("CT1 Ratio") to 9% of risk-weighted assets
  - By the earlier time of June 2012

Contraction in Bank Lending

- Banks affected by this rule have generally favour course of action (ii)
  - Reduce lending to customers and companies alike
  - “de-leveraging”

- ECB Bank Lending Survey (Q4, 2011)
  - The percentage of banks in the Eurozone reporting a tightening of their lending criteria came close to the percentage that prevailed during the credit crunch following the collapse of Lehman Brothers in 2008.

- Bank of Ireland illustrates the point:
  - Bank of Ireland reported (20 February 2012) it had reduced risk-weighted assets by 15.1% to EUR66.7bn

Contraction in Bank Lending

- Synchronized & large-scale deleveraging by Eurozone banks likely to have a negative impact on economic activity in the real economy
  - Exacerbating volatility of or depressing asset prices
    - Reduced credit supply
    - Asset ‘fire sales’

Solvency II

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Solvency II – Internal Models

- Welcome approach compared with Solvency I
  - Capital requirements are more risk sensitive
- Permits use of internal models
  - Internal models have been used in banking for some years
- Comparing financial strength of banks using internal models gives rise to difficulties
  - Critical details of internal models known only to banks and their regulators
  - Pillar III disclosures exempt commercially sensitive data

Solvency II – Internal Models

- Useful to look at issues arising in banking
  - Investors are becoming increasingly suspicious of the lowering of risk-weighed assets
    - Arising from parameter changes within internal bank models
  - Example: May 2011 Lloyds Banking Group Pillar III disclosure statement
    - Reported in the New York Times 24 November 2011

- Flexibility within the regulatory environment raises suspicions

Solvency II – Internal Models

- Internal models in banking gave false comfort to the public & taxpayer in the run up to the financial crisis
- Actuarial profession critical role to play in relation to Solvency II internal models
  - Ensure that lower capital requirements year after year **not** due to 'parameter changes'
    - Better communication with investors

Solvency II – Internal Models

- Insurers with a strong solvency position
  - Give investors transparency around risk capital reserving
  - Adopt Standardised Approach under Solvency II
  - Confidence in the share price of an insurer may be more valuable than a lower capital requirement

Conclusions on the Environment

Conclusions on the Environment

- Focus by consumers and companies on the repayment of debt
  - Driving down consumption & investment expenditure
- Falling disposable income
  - Government austerity programs and low growth in incomes
- Low levels of confidence among consumers
  - Falling house prices and high levels of unemployment
- Very tight conditions for the availability of credit for consumers and firms alike
- Synchronised move towards implementation of Fiscal Compact
  - Likely to slow economic growth in the short term

Conclusions on the Environment

- There is a shortage of effective demand in Ireland and many EU countries
- General thrust of public policy is doing little to address this situation
- Outlook: Very low or declining GDP growth for some time yet

Possible Implications for the Insurance Industry

Life Assurance

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Possible Implications for

Life Assurance - Savings

- The amount of income available for life assurance savings is likely to fall across much of Europe
  - Consumers directing disposal income towards debt repayment
  - Government austerity programs reducing disposal income through tax increases
  - Consumers' "balance sheets" showing an excess of liabilities over assets poor outlook for lump sum investments
- Uncertain times
  - Consumers are less likely to lock savings into long term products
  - Prefer bank deposits and other highly liquid investments
  - Solvency II likely to reduce products offering long-term guarantees

Possible Implications for

Life Assurance - Savings

- Investment results are a key source of earnings for life assurance companies
  - Fees for managing policyholder assets likely to be volatile

Possible Implications for

Life Assurance - Pensions

- Austerity measures threaten pension products
  - Tax incentives reduced or withdrawn
    - Changes in the taxation of retirement lump sums
    - Pensions levy
    - The relief from employer PRSI on employee pension contributions abolished
    - Universal Social Charge payable on employee pension contributions
  - Attractiveness of such products declines

- Consumer confidence in pensions products undermined
  - The threat to abolish higher rate tax relief for pension contributions
    - Pensions savings equation delivers a negative return on investment after tax for higher rate tax payers

Possible Implications for

Life Assurance - Pensions

- Final Solvency II rules for annuity business may lead to:
  - A significant increase the capital requirements for writing annuity business
  - Life assurance companies examining the risks inherent in annuity business more closely than in the past
    - Cost of purchasing an annuity with a lump sum will rise
    - This will push up pension funding costs
    - Simple economics suggests that participation in pension schemes is likely to fall as demand falls when price rises
- In Ireland and the U.K., annuities are the back-bone of much private pension provision

Possible Implications for

Life Assurance – Pensions Opportunity

- Defined benefit pension plans becoming increasingly unattractive
  - Implications of deficits for sponsors' financial statements
- Switch from defined benefit to defined contribution provides an opportunity for life assurance companies provided
  - Tax treatment of pensions not undermined further

Possible Implications for Life Assurance - Protection

- Demand for life assurance cover and mortgage protection policies will decline and remain subdued
  - Lower levels of lending & falling housing prices
  - Low growth in wages and salaries
- Competition in this sector is likely to increase significantly
  - Insurers focus on this market to make up for loss of earnings from saving market
- Higher competition is unlikely to lead to any significant earnings growth in the protection sector of the market

Possible Implications for the Insurance Industry

General Insurance

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Possible Implications for

General Insurance – Premium Income

- Demand for general insurance likely to fall in line with falls in GDP
  - Cost base may have to contract
- Competition is likely to intensify
  - Growth comes by gaining market share
- Commercial property & household sums insured
  - Likely to be underpinned by the floor of replacement cost as a basis for calculating such sums insured despite falling values of commercial & residential property

Possible Implications for

General Insurance – Premium Income

- The rise in number of unemployed & falling unit labour costs
  - Likely to put downward pressure on exposure for employers' liability insurance
  - *Quarterly National Household Survey*
    - Construction employment, a not insignificant driver of commercial insurance premiums, now stands at 108,000
    - A decrease of 60% from the peak of 269,900 recorded in the second quarter of 2007

Possible Implications for

General Insurance – Premium Income

- Consumers and companies focus on value for money and their costs
  – Insurance premiums will come under increasing scrutiny
  – Likely to lead to squeezed underwriting margins

Possible Implications for

General Insurance – Premium Income

- Interim management statement of an Irish general insurance company (30 April 2012)
  - General insurance market contracted in the first quarter of 2012 in line with economic activity
  - The market is very competitive as evidenced by the level of advertising spend and the *"pricing of business insurance risks"*

Possible Implications for

General Insurance – Cost of Claims

- Cut-backs in public sector spending may lead to a reduction in detection of penalty point offences
  - Detection of mobile phone use while driving, failure to wear a seat belt, etc. offences has declined from a peak in 2008 through 2009, 2010 and 2011
  - Detection of speeding offences showed a similar falling pattern in 2009 and 2010 but actually rose sharply in 2011
  - May lead to higher claims frequency or costs for private motor and commercial motor lines of business

Possible Implications for

General Insurance – Cost of Claims

- Automobile fuel usage has fallen from its peak in 2007
  - Possibly a combination of less driving and the use of more fuel efficient cars.
  - An interim management statement from an Irish general insurance company (30 April 2012)
    - Indicated that the reduction in miles travelled had contributed positively to its motor account

Possible Implications for

General Insurance – Cost of Claims

- Economic environment
  - Customers more likely to claim
  - Greater propensity to exaggerate claims
- Significant resources need to be dedicated to investigating possible fraudulent claims

Possible Implications for

General Insurance – Investment Environment

- The lower interest rate environment will not significantly impact general insurance companies
  - Short-term nature of their liabilities and corresponding investment portfolios;
  - Ability to re-price products on an annual basis
    - Strong pricing competition may militate against re-pricing increases

Possible Implications for General Insurance – Asset Volatility

- Advisors likely to examine the extent of balance sheet exposure to different asset classes
  - High levels of exposure to risky assets like equities and credit
    - Solvency risk
- Solvency II & the current climate will force general insurers to lower the risk profile of their investment portfolios
  - Moving away from long-dated debt, equities and non-investment grade bonds
  - Moving towards short-dated debt, investment-grade corporate bonds and cash

Possible Implications for General Insurance

- The directors of insurance companies never like to cut dividends
  - Most of shareholders buy insurance company stocks for their high dividend yields
- Dividend cut or change in pay-out ratio may be an early warning sign of:
  - Weakness in balance sheet
  - Weakness in solvency position
  - Deteriorating outlook for future cash flows

Summary

- Fiscal Compact
  - How it is implemented is critical
- Economic Environment
  - Consumers paying down debt & disposable income reduced by increased taxation
  - Contraction in bank lending
- Solvency II
  - Significant opportunity for the actuarial profession
- Life Assurance
  - Pensions opportunity may provide growth
- General Insurance
  - Not as severely impact as life assurance

Thank you for your attention

Discussion