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Financial Services

# Beyond the Crunch

## Insurers should see the silver lining



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## Introduction

Since June 2007, global financial markets have been battered by a credit and liquidity crunch that is without precedent – both in terms of the speed and ferocity with which it has affected financial institutions, and the extent to which it has affected apparently unrelated sectors.

The insurance industry has not escaped the turmoil. Several companies have realised losses in their credit-related businesses. Most insurers have suffered significant falls in share price over the course of the credit crisis, and in this regard they have suffered to almost the same extent as banks. There may also be further knock-on impacts, such as claims against Directors and Officers (D&O) cover from financial institutions embroiled in the crisis. In the wake of the credit crunch, the near-term priority for many banks is steadying the ship, re-setting strategies in readiness for a sustained period of tight credit conditions, and re-establishing investor credibility. But for insurance companies the way forward is less clear. Should they treat the current crisis as a sideshow, of interest perhaps to their investment professionals and risk managers but not to executive management? Should they follow the banking lead and batten down the hatches in anticipation of further adversity? Or should they see the current credit crisis as an opportunity, a once-in-a-cycle chance to buy attractively priced assets and expand into new business areas that have hitherto been too expensive or too competitive to consider?

Our modelling of the potential opportunity for insurers suggests that it is too big – €680 BN in annual global credit revenues too big – to ignore, in both the short-term and long-term. So we say “focus on the silver lining” and “bite the bullet”. But we don’t say “hit and hope”. Insurers need to consider quickly and rigorously what they need to do to exploit the opportunity within the bounds of their, perhaps revised, risk appetite, and they need to do so in full knowledge of what they are entering into. Now is the time to do that: not only are the assets cheaper, but more importantly the capabilities are for sale as well. Moreover, the opportunities are presenting themselves in a number of different markets, in a variety of ways. All of the opportunities exploit the unique characteristics of the insurance business and insurers’ capabilities – structural liquidity, strong risk management capabilities for non-standard risks, and direct access to corporates who are still looking for sources of capital, but for whom the traditional routes have all but dried up.

## Insurers and the credit crunch – initial uncertainty

European insurers have reported exposure to collateralised debt obligations (CDOs) and sub-prime mortgages (shown in Figure 1) that is not insignificant but is still relatively low compared to most banks and some North American peers<sup>1</sup>. At this point, those close to European insurers believe that their exposure to these types of credit assets is manageable. Nevertheless, from July to August 2007 European insurers were marked down to the same extent as European banks, experiencing roughly a 15% decline in market capitalisation, as illustrated in Figure 2 overleaf. Swiss Re's announcement of a €1 BN mark-to-market loss in late November 2007 increased market uncertainty around the impact on insurers, pushing share prices down further. Insurance stocks have recovered lately, but in the first months of 2008 the sector was dragged down by the broad downturn in equity markets.

**Figure 1: CDO, asset-backed securities (ABS) and sub-prime exposure of major European insurers**

	CDO and ABS exposure <sup>1</sup>		Sub-prime exposure		Write-down and value adjustments
	Exposure in €BN	as % of total assets	Exposure in €BN	as % of total assets	in €MM <sup>2</sup>
<b>Aegon</b>	20.8	6.6%	3.1	1.0%	820
<b>Allianz<sup>3</sup></b>	35.0	3.4%	1.7	0.2%	1,300
<b>Aviva</b>	2.6	0.6%	0.2	0.0%	NA
<b>Axa</b>	15.4	2.1%	2.2	0.3%	1,500
<b>Generali</b>	NA	NA	<0.1	0.0%	NA
<b>ING</b>	92.3	7.0%	3.2	0.2%	1,570
<b>Munich Re</b>	7.9	3.6%	0.6	0.3%	100
<b>Prudential</b>	NA	NA	0.3	0.1%	NA
<b>Swiss Re</b>	26.6	9.1%	2.0	0.7%	970
<b>ZFS</b>	18.8	7.3%	0.2	0.1%	20
<b>For comparison: AIG<sup>4</sup></b>	72.0	9.0%	21.8	2.7%	10.8

Sources: Company financial reports, analyst presentations and press releases, Société Générale and Fox-Pitt Kelton broker reports, Oliver Wyman analysis

1 CDO, ABS and sub-prime exposure at the beginning of the credit crunch (i.e. as of 30 June 2007)

2 Pre-tax, including unrealised losses, as reported up to 7 March 2008

3 Allianz's exposure and losses stem mainly from Dresdner Bank, its banking subsidiary.

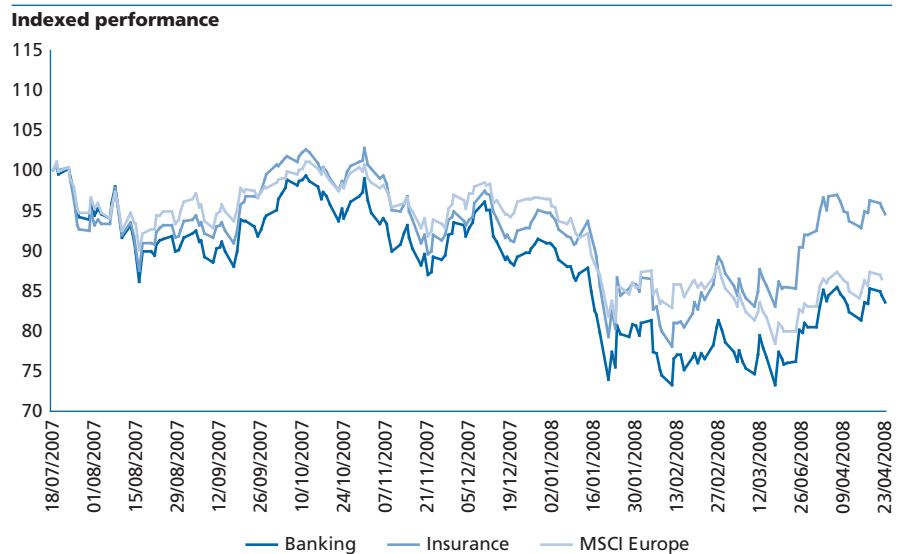
4 AIG's exposure to and losses from sub-prime credit are primarily driven by AIG's financial products business, not by investments in the general account

1 For example Citigroup's direct sub-prime exposure amounts to €37 BN, or 2.5% of total assets; AIG's sub-prime exposure amounts to €22 BN, or 2.7% of total assets

The fact that insurance stocks lost so much of their value in the initial weeks of the credit crunch and that they remained under pressure, despite their more manageable exposures, implies that investors lack a clear understanding of insurers' credit exposure, strategy and management capabilities. In particular, it seems that initially there was considerable lack of understanding in the market about individual insurers in three respects:

- Current exposure to credit – specifically to the asset classes most directly affected by the credit crisis, namely structured credit, CDOs and sub-prime mortgages
- Strategies (or lack thereof) for pursuing credit as an asset class and risk type
- Capabilities for managing and controlling credit risk

**Figure 2: Performance of European insurance vs. European banking stocks during the credit crunch**



Source: Datastream indices

It is not too surprising that insurers did not focus on credit during investor communications prior to the crisis. After all, credit risk is a relatively small part of insurers' overall risk profile – around 20% of the overall risk for a typical European life insurance company, much less for non-life insurers – as the equity bear market of 2000-2003 had left them in cautious mood and wary of taking on significant levels of financial risk, credit included. So, on the one hand, insurers had manageable credit exposures at the beginning of the crisis, but on the other hand this was not appreciated by the market. Many insurers did not necessarily have at their fingertips an accurate quantification of their exposure to specific credit subsectors, or a well-rehearsed disclosure strategy for credit that could be easily packaged for communication to the outside world. With a few exceptions, most insurers did not have a sufficiently clear description of all their credit investment and risk management capabilities, organisation and processes.

## The medium-term opportunity

For many insurers the near-term instinct might be to curb risk-taking, and wait on the sidelines to see how the credit and overall market situation develops. In our view there are several reasons why insurers should consider taking a more aggressive approach.

First, our estimate of global revenue and profit pools has shown that credit represents a sizable opportunity with global annual credit revenues of ~€680 BN spread across the retail, commercial and public sector. More importantly, there are a number of segments that display through-the-cycle return on risk-adjusted capital well in excess of 20%. Insurers are currently underrepresented in this market.

Second, and perhaps most importantly, insurers have an advantage when taking certain forms of credit risk:

- Insurers tend to be “long liquidity” – Due to the long-term commitment of the policyholder, insurance liabilities by their nature tend to be illiquid, in particular in the case of life insurance. In addition, the timing of cash flows, with insurance premiums paid in advance of claims, means that insurers are generally longer-term investors. This allows insurers to invest in relatively illiquid assets. The past months have made apparent that credit is often inextricably bundled with liquidity risk, particularly in leveraged investment structures. Excessive profits in credit are typically found in those parts of the credit spectrum where information is scarce and structures complex, the same areas where liquidity is likely to be lowest. As providers of liquidity, investing in select credit assets allows insurance companies to pick up liquidity premiums while still being able to match their liability cash flows
- Credit risk diversifies well with insurance risks. On a marginal basis, the capital requirement for taking credit risk is lower for insurance companies than it is for banks, which already have a significant exposure to credit risk
- The price or reward for taking liquidity risk is again strong. In the last few years this was bid down to negligible levels, undermining insurers’ ability to monetise the illiquidity of their liabilities. Now that the reward for providing liquidity has recovered to beyond historical norms, the ability to originate illiquid assets and manage credit/liquidity positions will increasingly be a key component of competitive advantage

Together, these attributes suggest that credit should have its place in the long-term strategic asset allocation of most insurers.

In addition to the structural advantages that many insurers have as providers of liquidity or investors in credit, there are several reasons why now is a particularly good time to enter or expand their presence in the credit markets:

- Credit markets have dried up and have not yet recovered; pricing has moved back to largely rational levels and it is likely that the point has been reached where there are attractively priced credit opportunities. Securitisations and other secondary market transactions are currently effectively closed; as a result banks are looking for other means to pass on credit risk and maintain lending capacity. This is one of many opportunities that insurers could pursue
- In some areas the entire market delivery mechanism has seized up, meaning that many viable companies looking to raise debt are unable to access the capital providers. Insurers with a private placement capability have an opportunity to bypass the market makers all together, leading to a greater capture of the typical origination cost associated with debt issuance
- Talent is becoming available as banks are reducing headcount in their credit research, underwriting, structuring and trading areas. Now is a good time to buy credit talent and intellectual capital and to build credit capabilities

However, despite the attractiveness of credit for insurers, and the currently favourable market conditions most insurers risk missing out on this opportunity because they lack:

- **A vision for credit and liquidity**  
Many insurers lack a well defined credit risk appetite at the strategic level. Senior executives too rarely get involved in deciding overall exposure to credit, except when reacting to credit crises. Credit risk management is often focused on the concentration risk and potential downside rather than the risk/return trade-off. As a result, credit decisions tend to be delegated, with bold strategic moves being neglected and displaced by a series of minor tactical tweaks
- **The capabilities and tools needed to assess credit risk and return**  
While many insurers have put in place global counterparty exposure measurement systems, most of them lack detailed independent credit research and assessment, and rely on public ratings instead. This severely limits their ability to identify and take on the more attractive risk segments within the credit space

- **The ability to integrate different business silos**

Credit risk affects all aspects of an insurance company's operations – clearly it impacts the credit investment business directly, but it also affects equities and alternative investments, wholesale funding costs, insurance claims (e.g. for political risk and trade credit insurance), reinsurance and liability product pricing (e.g. for fixed annuities, immediate annuities and guaranteed investment contracts). Having a clear view across all aspects of credit, across regional markets, and across the Chief Investment Officer, Chief Financial Officer, Treasurer and Chief Risk Officer functions, and being able to make decisions quickly involving these various functions, is critical

## Seizing the opportunity

Insurers who want to seize the credit opportunity must address each of the aforementioned issues in parallel. All three are necessary to get over the credit decision logjam in the first place, to make best use of their capabilities and balance sheet and to avoid being at the wrong end of resulting transactions.

### Vision for credit risk taking

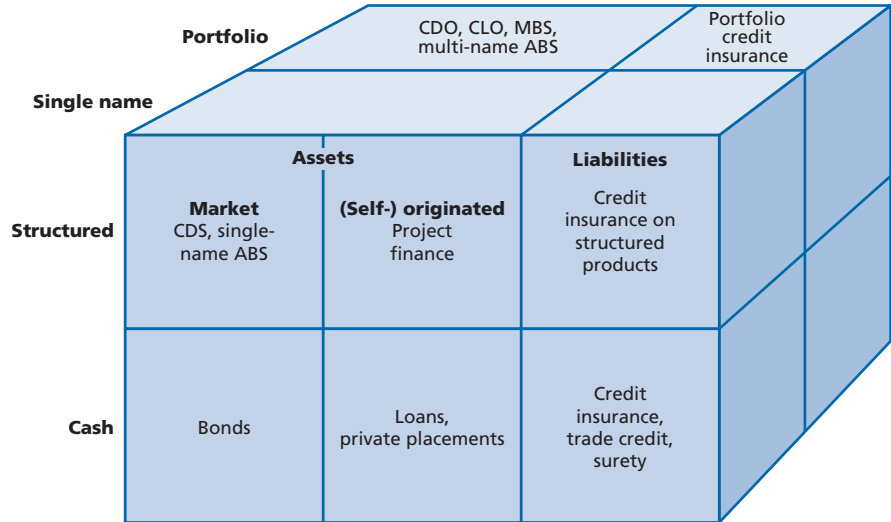
An insurer's starting point is to understand its overall appetite for credit risk, and the most attractive mechanisms for taking credit risk.

On the asset side of the balance sheet, insurers need to decide where they want to be on the credit and liquidity spectrums – which rating levels and credit durations are acceptable, and how much credit risk should be taken through tradable credit instruments versus illiquid investments or private placements. For liquidity risk appetite the duration of liabilities and any optionality embedded in them is a key input, as is a firm framework to manage the extent to which credit and insurance risks could give rise to liquidity requirements. Currently, the vast majority of insurers' credit-linked assets are invested in liquid or traded bonds via secondary markets. But given the long-term liquidity advantage and short-term market situation described above, there may be more value in non-traded credit assets in both the short- and long-term, whether through origination or over-the-counter trades.

Insurers will also need to form a view as to how much credit risk should be taken via cash/plain vanilla products versus more structured products, and via single-name instruments versus instruments on a portfolio or basket basis. These decisions have significant knock-on effects on the capabilities that will be required.

This range of considerations for developing a strategy for the credit markets is summarised in Figure 3.

**Figure 3: The credit cube**



Note: Collateralised debt obligation (CDO), collateralised loan obligation (CLO), mortgage-backed security (MBS), asset-backed security (ABS), credit default swap (CDS)

## Credit capabilities

As in all risk-taking activities, execution is critical. The capabilities required for successful credit risk-taking are:

### ■ Transaction-level capabilities

In today's market it is not acceptable to make investments solely on the basis of rating agency assessments. Hence, to decide which credit-linked assets to invest in and when to invest, insurers will need an appropriate infrastructure for assessing, valuing and monitoring each asset class. To enter traditional credit markets such as name-level bonds or CDS, insurers need teams that can assess the creditworthiness of individual corporates and financial institutions. To play in the ABS and CDO markets they must ensure that they have access to information on the underlying collateral and that they can run cashflow scenarios accounting for the correlated behaviour of the underlying. Insurers investing in credit-risky assets will also need the ability to (re-)value their investments on an ongoing basis, which may require mark-to-model capabilities for these assets as sophisticated as those many are developing on the liability side

### ■ Active credit portfolio management

A robust credit portfolio model helps the insurer understand the credit portfolio in its entirety, including interactions and correlations between individual exposures. This helps to avoid costly concentrations and enables an active approach to portfolio

management that allows dynamic rebalancing and hedging where required. Of course these tools are only as good as the data and assumptions that go into them, so it is imperative that the insurer also has people with the depth of knowledge and judgment to be able to make rational and informed decisions off the back of their output

#### ■ **Asset liability management**

Where credit-linked assets are held to back existing insurance liabilities, the interaction of assets and liabilities needs to be understood and managed. Successful asset liability management requires “divorcing” interest rate duration from credit duration, with decisions regarding yield curve positioning taken independently from decisions regarding credit and liquidity positioning

Credit capabilities are not easy to develop from scratch. However, as banks retrench plans to aggressively grow credit areas, talent and intellectual capabilities are becoming available. This provides insurers with a great opportunity to cherry-pick the best and brightest from those organisations that no longer see their future in credit.

### **Integrated credit risk management**

Successful credit investment requires the ability to manage the entire credit book on an integrated basis. All credit-linked positions on the balance sheet need to be visible to a central unit. This includes credit risk on the asset side as well as on the liability side, across all business units and countries. Making this work requires a well thought out credit organisation with streamlined reporting and decision processes, and clear lines of responsibility. The organisation also needs to be flexible and responsive, to support attractive opportunities as they arise.

Finally, to be able to assess the impact of credit risk-taking on the group-wide risk profile, it is important that the diversification between credit risk and all other risks taken, and indeed potential credit risk concentrations, are both well understood and monitored on an ongoing basis.

## Ready to get beyond the crunch?

For those insurers with the appetite, capacity and strategic will, now is a great time to build capabilities in credit and to take advantage of both the short-term opportunities that present themselves, and the long-term advantage inherent in the insurance business model.

Insurers' success in seizing these opportunities will depend on their understanding that this is a one off opportunity to capture margin normally accruing to other capital market players, and on their ability to take the right actions to capture this opportunity. This requires clarity of their credit vision, an ability to upgrade their credit capabilities, and success in combining strong credit risk management with sharpness of decision processes and execution. Building these success factors is not easy, but it is an achievable goal for those insurers with strong existing experience in managing risk and who are prepared to invest in acquiring the talent and intellectual capital that is becoming available. Moreover, insurers will have to act quickly and decisively while the window of opportunity to grab a piece of the €680 BN revenue pool is open. It will close once traditional credit market participants have been able to regroup.

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