The Actuarial Profession
making financial sense of the future

Highlights conference
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Economics Update
23rd February 2010

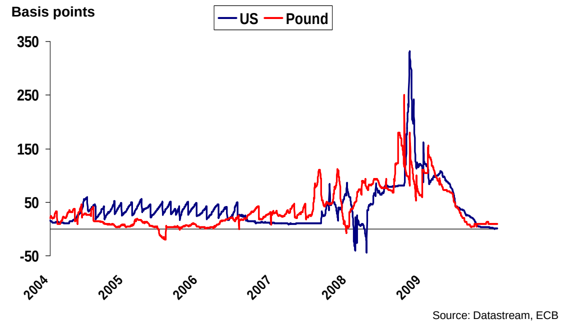
Agenda

- **Economics update**
- Implications for the insurance industry
- Questions and discussion

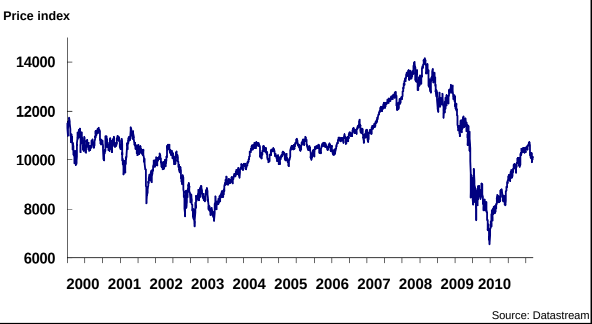
Minsky

- The longer there is economic stability, the more likely the financial system becomes unstable as economic agents take on more risk
  - Hedged borrowers (can meet all payments)
  - Speculative borrowers (interest only)
  - Ponzi (neither, rely on rising asset prices to roll over loans)
- Financial innovation (why different this time)
- "Minsky moment": lenders get cautious, and not only about over-leveraged structures
- Panic, stampede out of market, bankruptcies
- Need to intervene decisively to prevent meltdown
- Under-priced debt, overpriced assets, over-extended borrowers, undercapitalised lenders

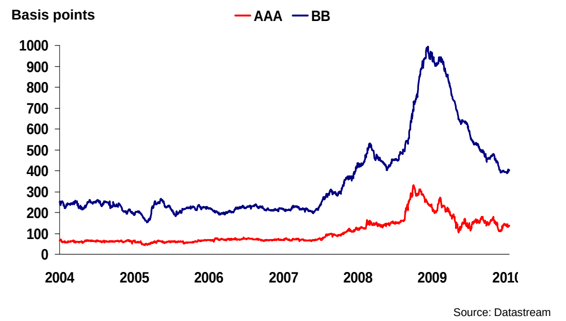
3-month interbank spreads over policy rates



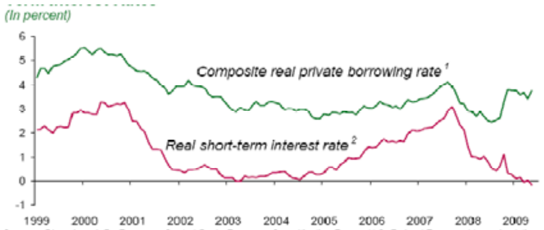
Dow Jones Industrials



US Corporate spreads
(over 10-year US Treasury bonds)

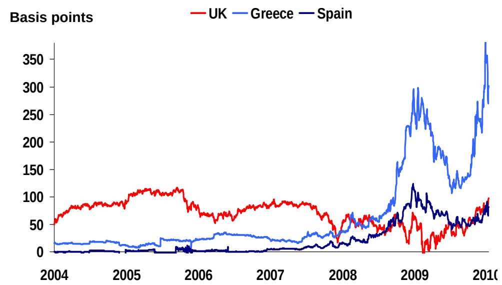


Composite real private borrowing rate and short-term interest rates



Sources: Bloomberg L.P., European Central Bank; European Securitisation Forum; U.S. Federal Reserve; Haver Analytics; and IMF staff estimates.

Government bond yield spreads (over German govt bond yields)

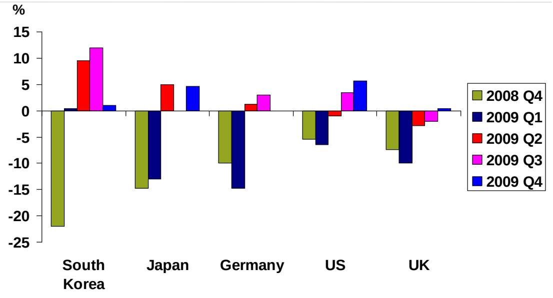


Source: Datastream

Financial markets

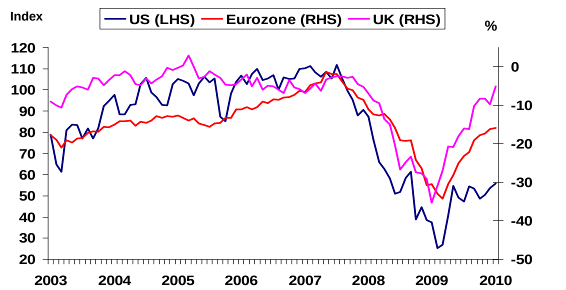
- Financial conditions improving more quickly than expected
- Debt and equity markets have re-opened for high quality large corporate issuers
- But small/medium still reliant on bank lending
- Fewer banks tightening lending criteria but still cherry-picking and expanding margins
- Transactions market re-starting with pent-up demand for restructuring
  - Price, funding still issues
- Securitisation market still pretty much closed
- IMF expects total bank write-downs of $2.8tr – $1.3tr to go
- Financial crisis turning into sovereign debt crisis?

GDP growth 2008 Q4 to 2009 Q3 (annualised)



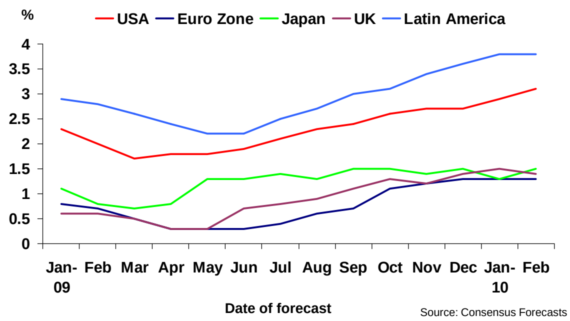
Source: IMF

Consumer confidence



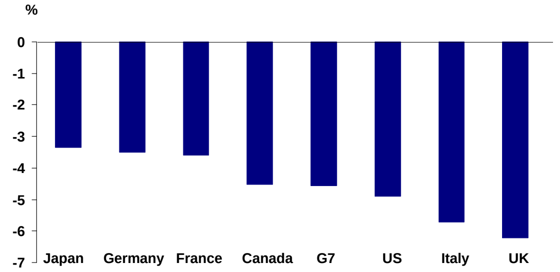
Source: Datastream; Eurostat

Forecasts for GDP growth in 2010



Source: Consensus Forecasts

OECD output gaps (% of potential GDP) (2009 Forecasts)

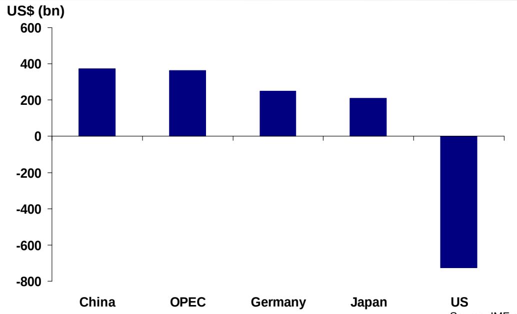


Source: OECD

What's going on globally?

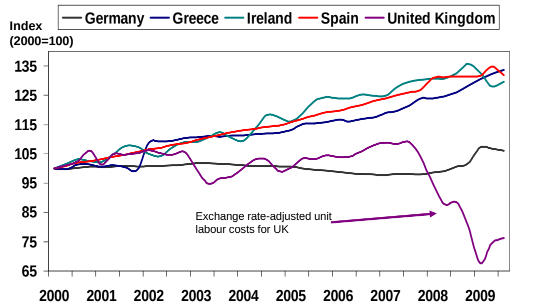
- World stopped - collapse of confidence and seizing up of banking system post-Lehman
- Collapse of demand for goods transmitted back down supply chains
- Production cut-back and supply from stock
- First fully synchronised global recession
- Stock cycle reversing
- Extraordinary monetary and fiscal measures supporting demand
- Patient recovering from cardiac arrest but still on life-support
- Crisis has laid bare structural problems

Global imbalance - current account positions (2007)



Source: IMF and OPEC

Unit Labour Costs



Source: ECB, OECD

Public finances and international trade (Europe)

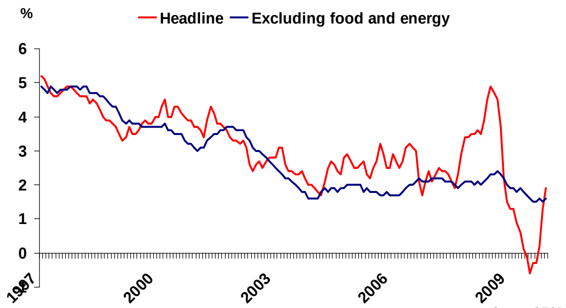
	Public debt (2009) (% of GDP)	Budget deficit (2009) (% of GDP)	Current account (2009) (% of GDP)
Greece			
Portugal			
Spain			
Italy			
Ireland			
UK			
Germany			

Source: Goldman Sachs Global Economics Weekly (Jan 2010)

EMU problems

- Economies not converged
- Some suffering *structural* public finance problems
  - Monetary, not fiscal/political union
- Some suffering *structural* competitiveness problems
  - Can't adjust exchange rate in eurozone
  - Faced with years of deflation
- Will EMU survive?

OECD inflation

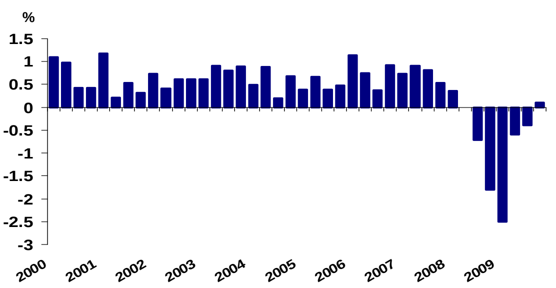


Source: OECD

Global outlook

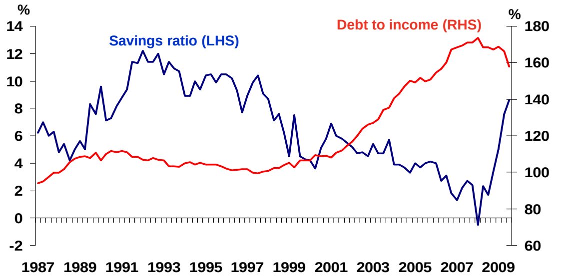
- Short-term recovery – output bounce on back of re-stocking could be quite strong. Certainly year-on-year growth rates could look robust given weakness late 2008/early 2009
- Longer-term three views
  - **Virtuous circle** - as long as authorities continue to do right thing, recovery will strengthen, debt burdens easier to handle and banks heal more quickly
  - **Not a normal recession** – excesses of past have to be paid for with slow and fragile growth
  - **Vicious circle** - world sinks into "debt deflation" as high levels of debt prevent demand from strengthening sufficiently to avert deflation. Then rising real burden of debt feeds into increasing defaults, further deflation and downward spiral
- Keep fingers well and truly crossed

UK: GDP growth (quarter-on-quarter)



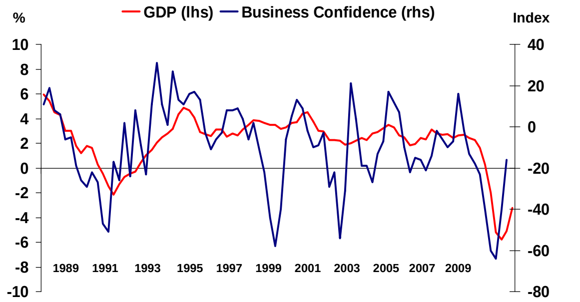
Source: Datastream

UK: Household debt to income ratio and household savings ratio



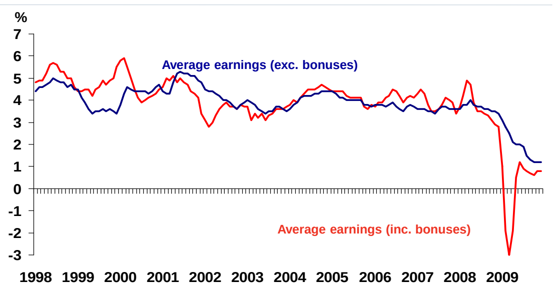
Source: ONS

UK Business Confidence and GDP



Source: Datastream

UK: Wage growth



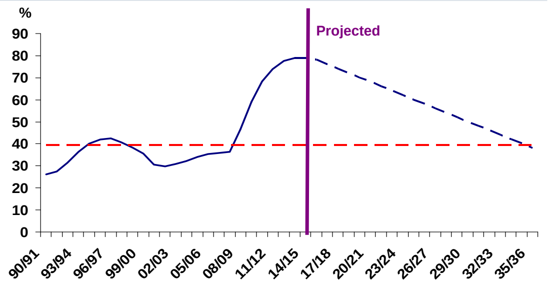
Source: ONS

Pre-budget Report 2009 forecast

% change	2009	2010	2011	2012
GDP	- 4 ¾	1 ¼	3 ½	3 ½
Household consumption	- 3	¼	3	3
Gross fixed investment	- 14 ¼	-1 ¾	4 ½	8 ¾
Govt consumption	2	1 ¼	- 1 ½	- 2
Exports	- 10 ¾	2 ¼	4 ¾	5 ¼
Manufacturing output	- 10 ¾	1 ¾	3 ¾	3 ¾
Public borrowing £bn	177.6	176	140	117

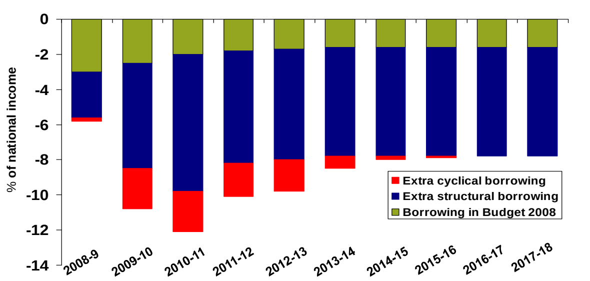
Source: HM Treasury

Public sector net debt (% GDP)



Source: HM Treasury

Deterioration in Treasury borrowing forecasts between Budget 2008 and Budget 2009



Source: HM Treasury

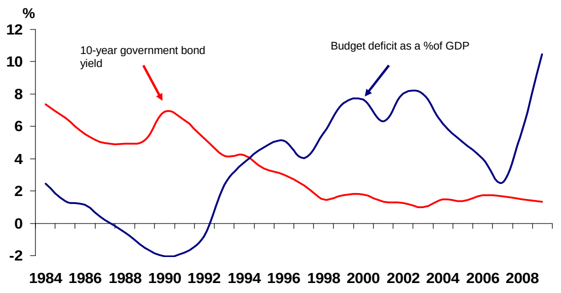
Why so intractable?

- Majority of deterioration assumed to be structural – 6-8% of GDP – ie won't go away even when output back to potential
- Recession may have *permanently* reduced productive potential
  - Capacity closed won't re-open
  - Long-term unemployment and youth unemployment very stubborn
  - Lose skills
  - Labour force shrinks if migrants go home
  - Less worker mobility
- And UK has lost "revenue rich" activities (financial services, property transactions) and future growth export-led
- Raise taxes/cut spending
- Inflationary exit?

What can you do?

- Learn to love the deficit until recovery established
- But long-term solvency issues - demographics
- Raise tax and/or cut spending – politically viable?
- NIESR – to close UK gap by 2015, perm any three:
  - Raise pension age to 70
  - Income tax basic rate up 7p
  - VAT base extended to all items (except food, children's clothes)
  - Shed 100,000 public sector jobs/year (close hospitals, schools?)
  - Reduce real public sector wages by 10% over 5 years
- Whatever you do it will hurt – strife and strikes, poorer public services, higher taxes/charges
- Risk of inflationary exit has risen

Japan government borrowing and 10-year bond yields



Source: OECD, IMF

Pension and saving issues

- Fund valuation
  - Asset price falls, future rates of return
  - Funding liabilities – will government bond yields remain low?
- Return to “normality”?
  - Blip or long-term?
  - Will economy return to long-term growth rate (but permanent step down)?
  - Inflation or deflation? (pensions rise in real terms)
  - Does rising government debt mean higher gilt yields?
- Assets traditional vs unconventional

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- **Implications for the insurance industry**
- Questions and discussion

Product design

- Customers have lost wealth and face slower income growth, public spending cuts/user charges and tax increases
- Need to raise saving to restore wealth and prepare for the future
- But many customers disillusioned with savings and pensions products
- Need less complicated products which offer some protection
- Need alternatives to traditional annuity products

Reserving

- Outlook is for continued low yields
- Guarantees costs remain high
  - Hedging programs may not be effective in volatile markets
  - Cost of hedging is likely to be more than originally assumed
- Bond spreads narrowing

Capital management

- Market turmoil had highlighted the need for stress testing
- Has the view of a ‘one in two hundred year’ event changed?
- Market turmoil has highlighted the need for more frequent reporting/monitoring – even monthly may not be enough

M&A activity

- Expect further industry consolidation
  - To achieve scale and diversification
  - Add product lines and management talent
  - But many finding it difficult to raise capital to finance deals
  - May see more interest in securitisations
- May see banks selling off insurance companies

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•Implications for the insurance industry

•**Questions and discussion**