# Lessons Learned from the Financial Crisis

GIRO Conference and Exhibition 2009
Edinburgh, 7 October 2009

Thomas Hess

Chief Economist, Swiss Re

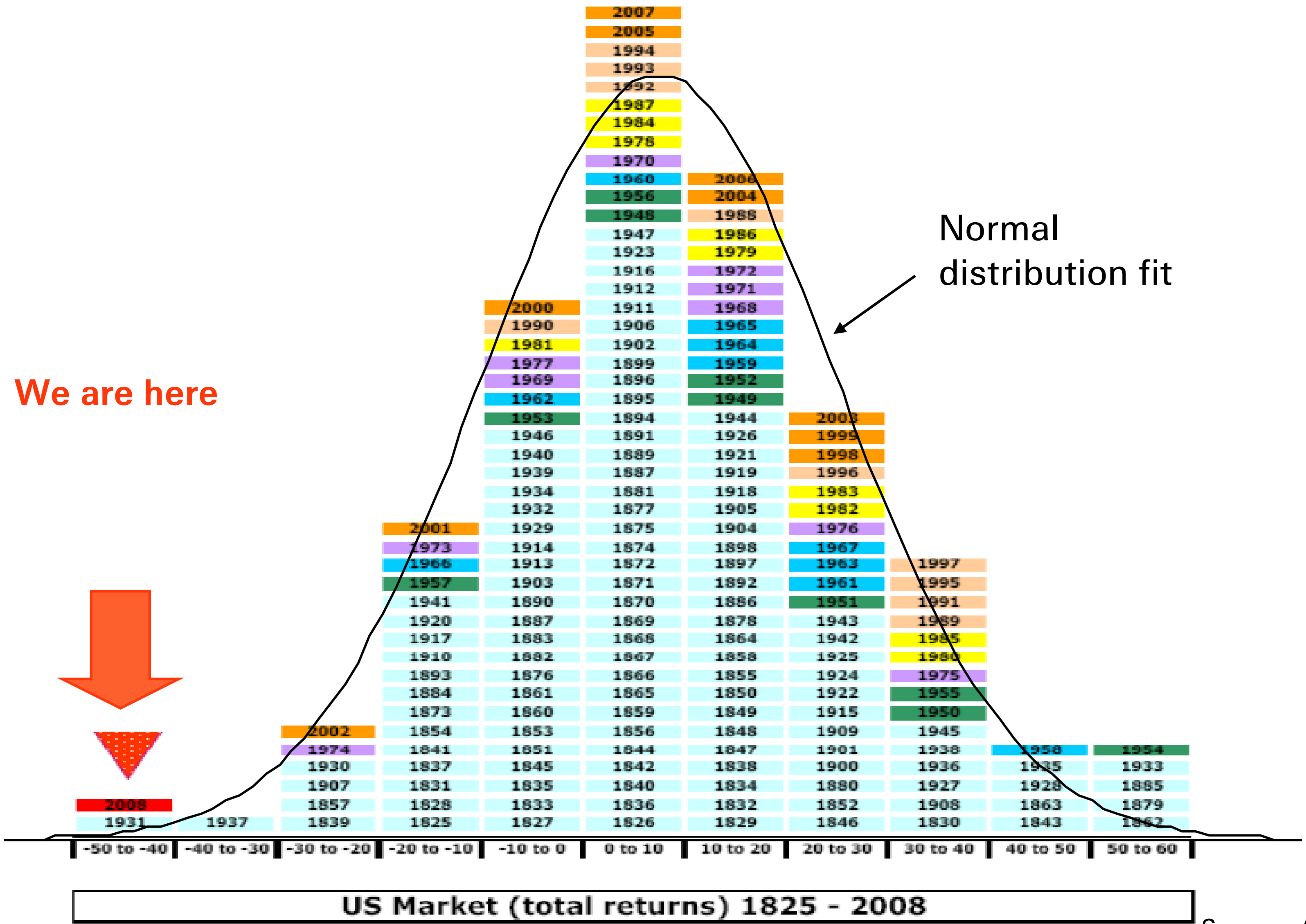
Head of Economic Research & Consulting

Swiss Re

# Agenda

- The crisis and the lessons learnt
- The lessons from an insurance perspective
- Looking forward

# This crisis is a low frequency high severity event!




Source: Axa

# Characteristics of the crisis and lessons

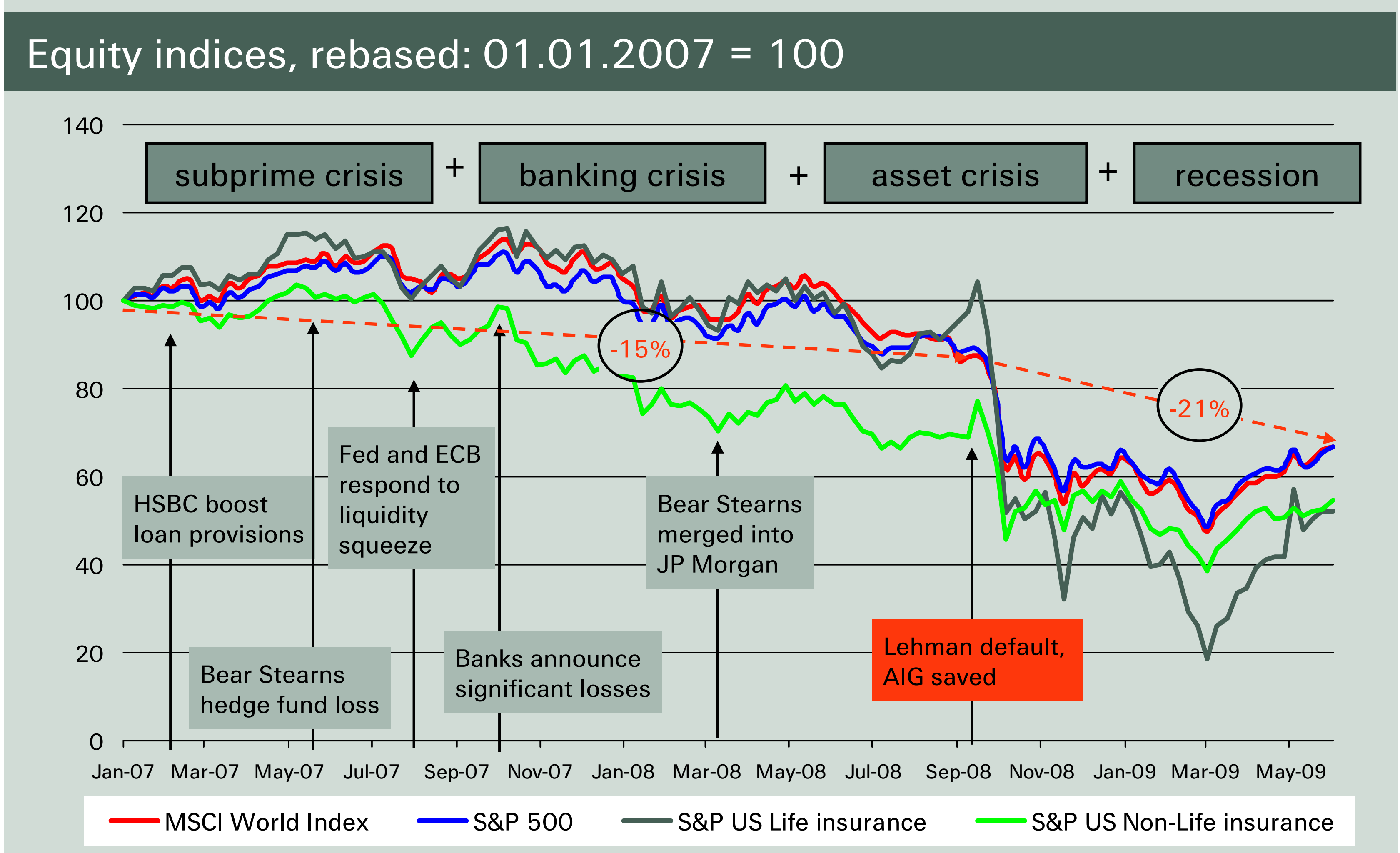
Swiss Re

- Huge parts of the banking system and capital markets stopped working
- Asset markets dropped dramatically, often due to illiquidity issues; valuations and correlations between asset values have been distorted
- Hedging became very expensive, hedges worked imperfectly, financing instruments became extremly expensive or unavailable
- A financial crisis of major size causes also the real economy to collapse. It was surprising how rapidly, strongly and simultaneously the real economy reacted

***In a systemic crisis many markets don´t operate as usual – the issue is the accumulation of problems***

# The crisis developed slowly until Lehman defaulted

Swiss Re




Source: Bloomberg, Swiss Re Economic Research & Consulting

# Lessons

- A global banking crisis is still possible in our modern world; the superior risk management of banks was and is an illusion

- There are means to prevent systemic crises. Regulation and infrastructure can be improved. It was also a crisis of execution and partly political will

- There are also means to limit the crisis impact on the real economy and capital markets; there is an important role for governments in such a situation

- Crises are not only difficult to forecast but also the development of such extreme crises is extremly difficult to predict. Crisis management is not a rock solid science

***The banking system needs better regulation and execution of its regulation plus it needs better infrastructure but governments should not run the banks***

Swiss Re

# Agenda

- The crisis and the lessons learnt
- The lessons from an insurance perspective
- Looking forward

# Insurance industry withstood the crisis, but was not unscathed

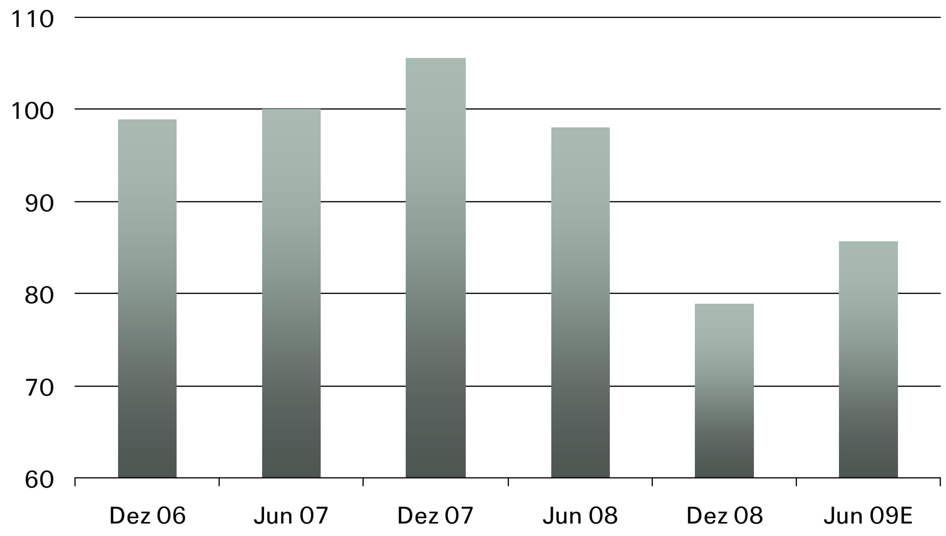
Swiss Re

| Balance sheets adversely affected... | ...last-resort solutions relied upon |
| --- | --- |
| ■ Massive asset write-downs resulting in realised and unrealised losses<br>■ Ratings downgrades<br>■ Liquidity risk surprises<br>■ Complex products left unhedged | ■ Back-up funds tapped<br>■ Dilutive capital raised<br>■ Government bailouts |

***Also insurance is affected but there is no comparison to banking***

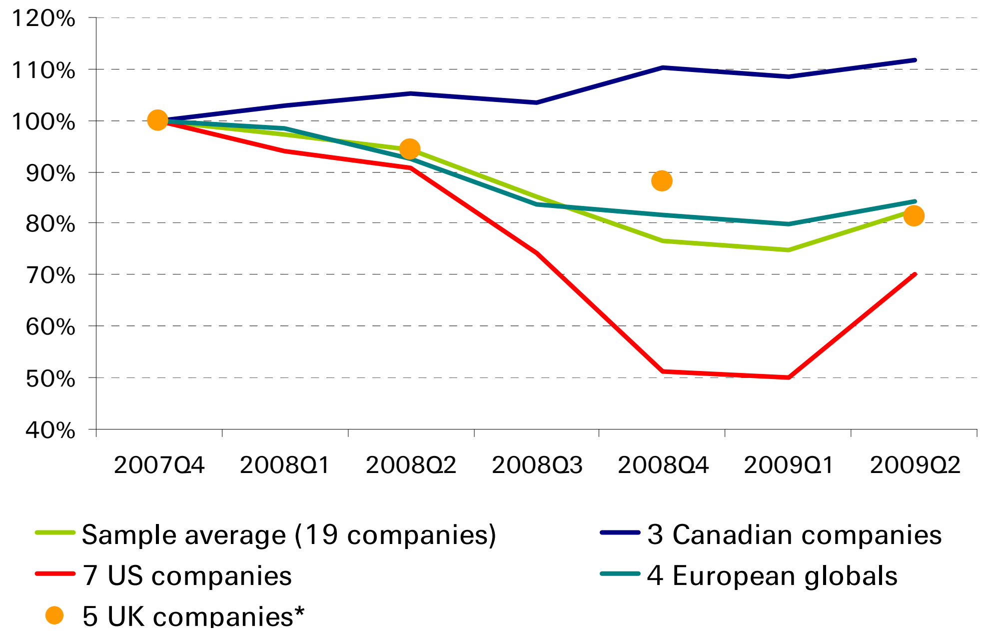
# Insurers capital situation

## Shareholder's Equity*
Index Jun 2007=100, USD




*30 major insurers

## Shareholder's Equity by country*
Index Q4 2007=100, USD




Sources: Company reports, Bloomberg, Swiss Re Economic Research & Consulting

***Between end of 2007 and end 2008 non-life insurers lost 20%, life insurers 40% of their shareholder´s equity. Since the begining of 2008 shareholder capital increased by 10%.***

# Lessons for insurers

- Insurers can hardly remain unaffected by the type of crisis just experienced → that is why capital has to be put aside for market risk

Important lessons for risk management

- Correlations in tail events are totally different → important implications for asset/ liabilty management
- Many financial instruments are very expensive/work imperfectly/ work different / are not available in a crisis → important issue for corporate finance

***Given the dimension of the crisis the negative surprises in insurance remained limited; there are important lessons for risk management however***

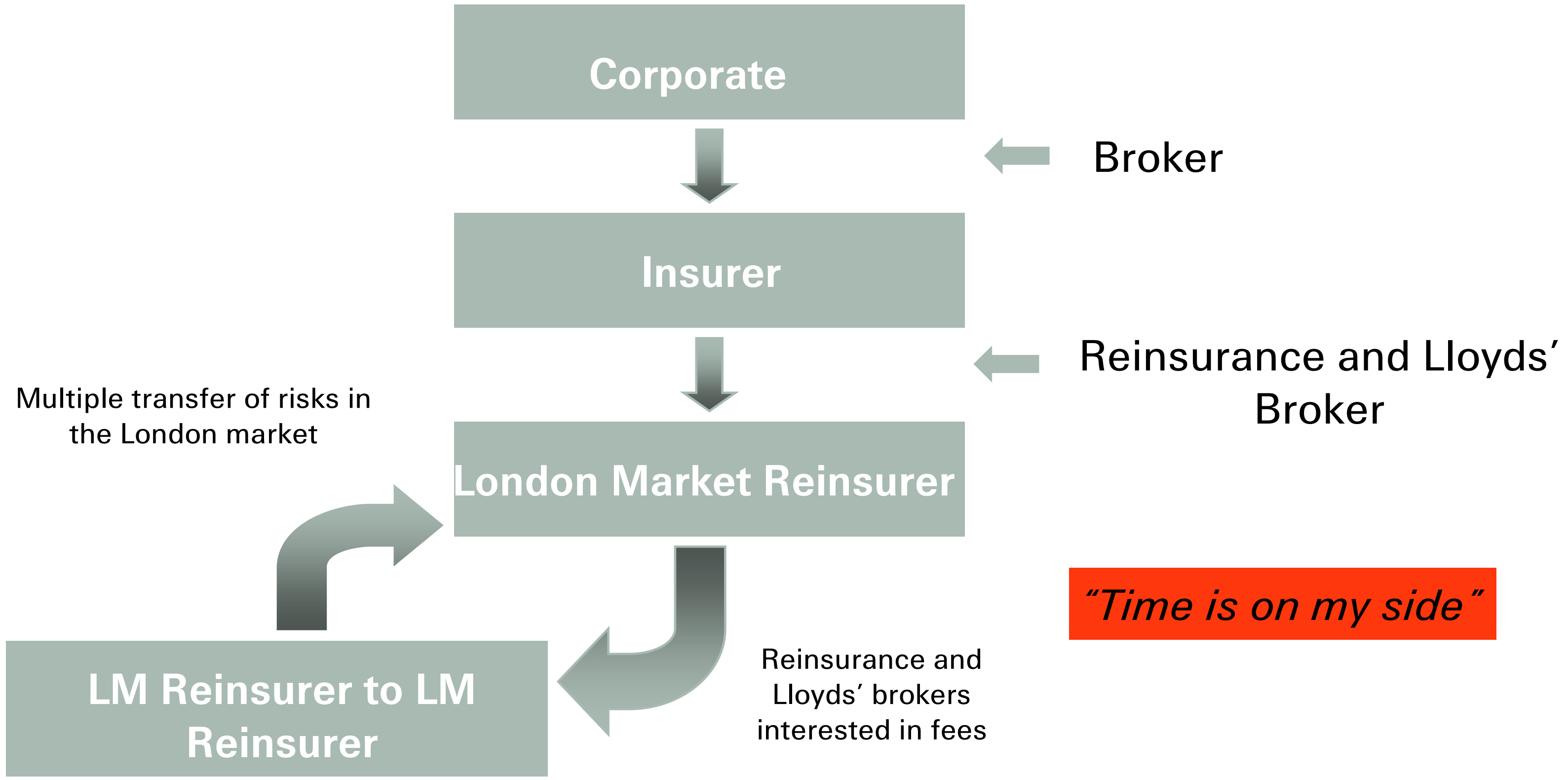
# ... continued

- The crisis did not come out of the blue but developed slowly; there is time to react and prepare
- For being among the winners you had to realise the crisis earlier than competitors and act on it
- Managing a crisis is different from day to day management

***Companies cannot prevent a systemic crisis to happen but can manage it better***

# Subprime Crisis in Insurance: The London Market Excess of Loss Spiral (LMX)

Swiss Re




Slide 1

***A key difference between banks and insurers is that insurers have time to absorb even big shocks***

# Insurance industry to raise its voice, as regulatory environment evolves

**Key objectives for the industry**

| | |
|---|---|
| **Emphasise (re)insurance specificities** | ■ Differentiate between the business model of (re)insurers and banks |
| **Promote sound risk and capital management** | ■ Establish economic and risk-based regulatory framework |
| **Maintain market access and level playing field** | ■ Secure governments' commitments to open trade and fair competition |
| **Achieve accounting convergence** | ■ Enforce market-consistent valuation and avoid pro-cyclicality |

***Insurance and reinsurance are part of the solution, and not sources of the crisis***

Swiss Re

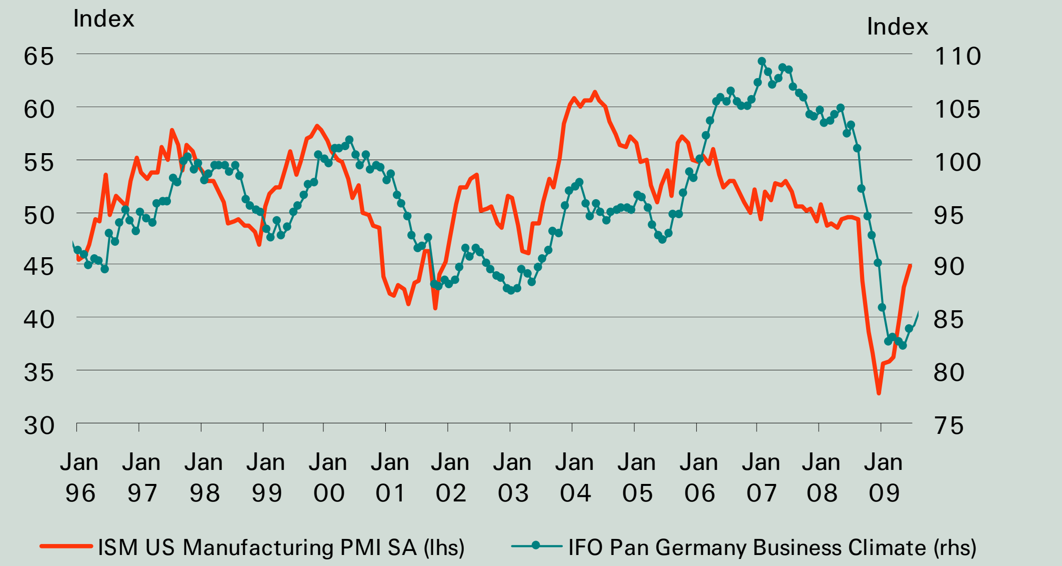
# Agenda

- The crisis and the lessons learnt
- The lessons from an insurance perspective
- Looking forward

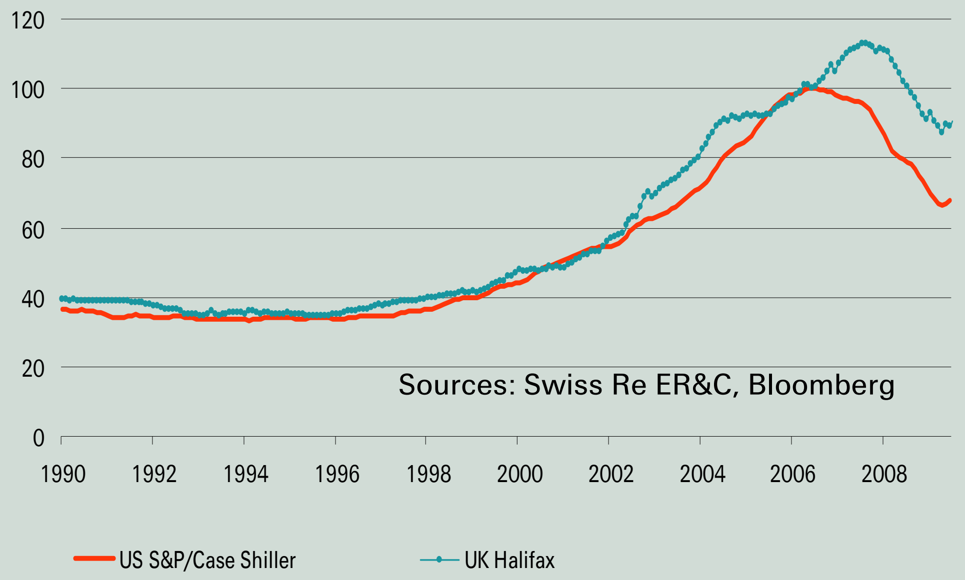
# Global economy: signs of bottoming out confirmed

Swiss Re

## Business sentiment: United States & Germany




## House prices, rebased 30.06.2006 = 100

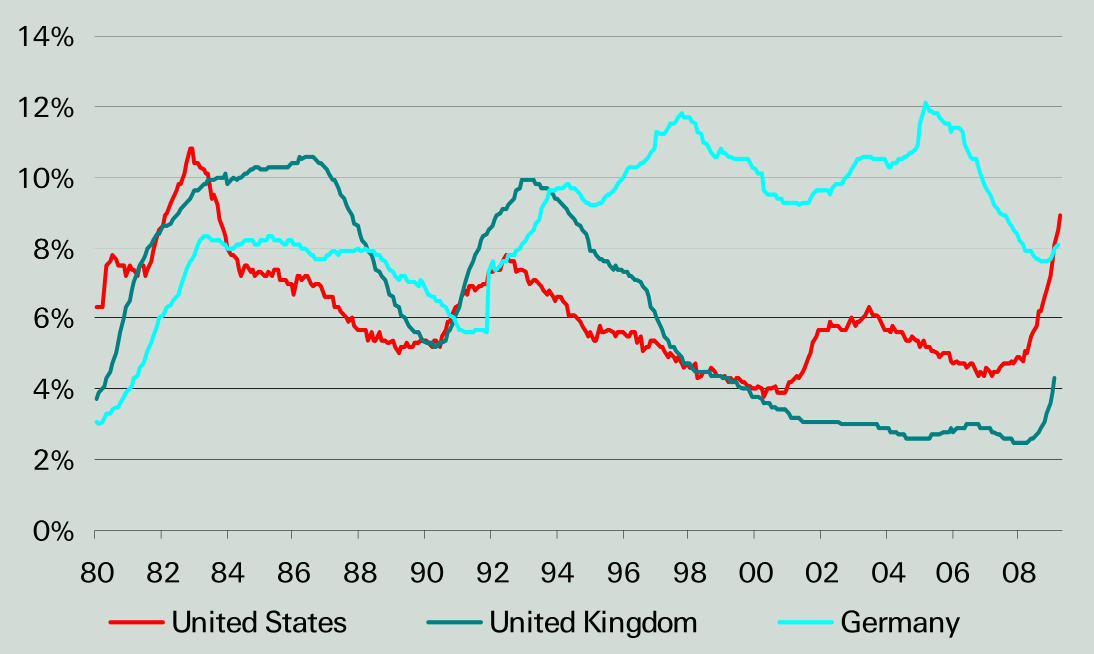



***There are signs of improvements but the recovery is not assured***

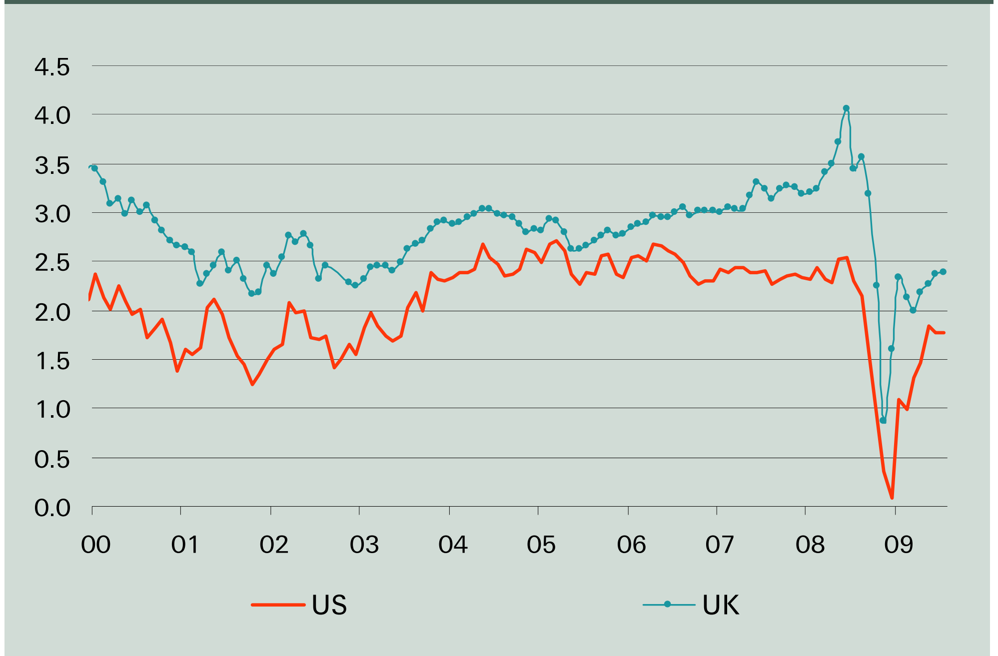
# Global economy: unemployment will rise further; inflation remains under control

Swiss Re

## Unemployment rates




## Break-even inflation, 10yr Bonds (percentage points)




Sources: Swiss Re ER&C, Bloomberg

***For unemployment to peak or inflation to rise substantially it needs a strong recovery, which does not seem likely until 2011***

# Self sustained recovery probable but still not certain

Swiss Re

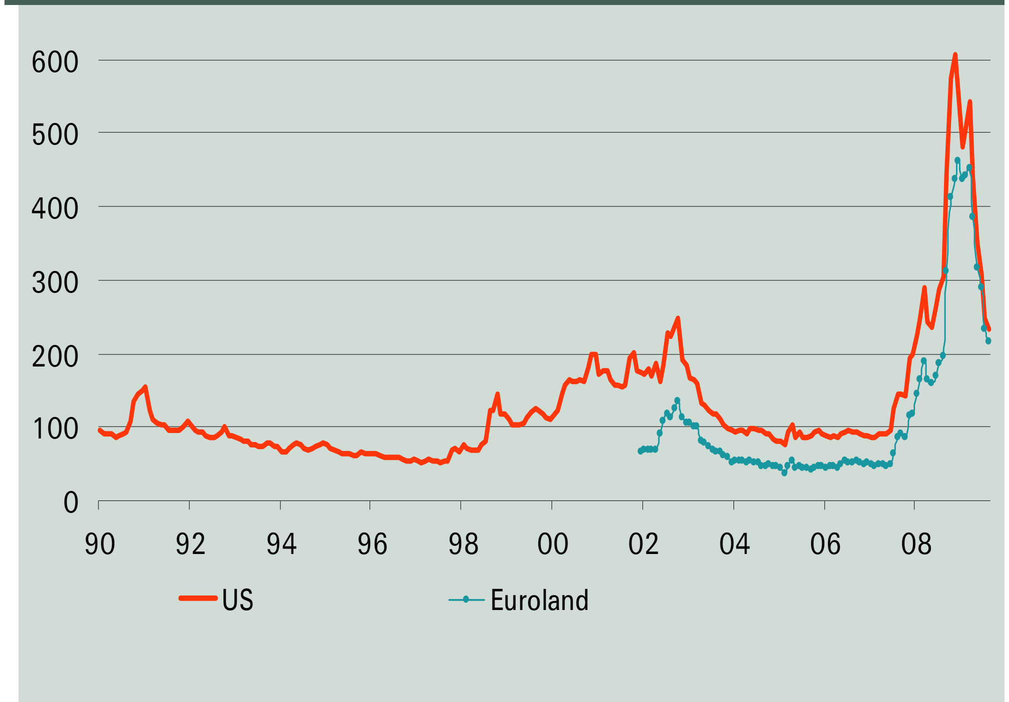
- Positive
  - Recovery is under way, government impulses are massive
  - It is expected that demand for durable goods and capital goods kicks in over the course of 2010
  - Inflation is not an issue as long as capacity utilisation remains low

- Negative
  - Unemployment will increase substantially before it will peak (in Europe it is currently held back)
  - The recovery is financed through increasing government debt, which is difficult to maintain in the long run

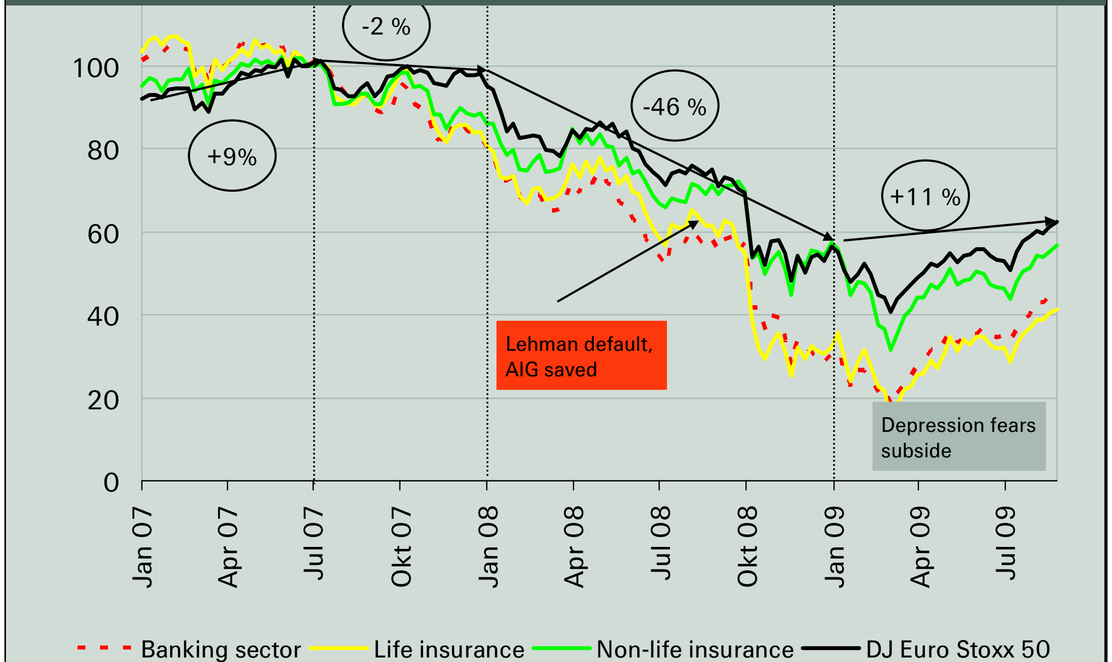
- To watch in 2010
  - Will private demand pick up enough to allow governments to gradually withdraw?
  - Is the recovery strong enough to reduce unemployment?
  - Inflation needs attention, when the economy is back on track

# Credit spreads down, equities up – more potential for improvements

Coporate bond spread (Investment Grade) (basis points)




European equities, rebased: 01.01.2007 = 100



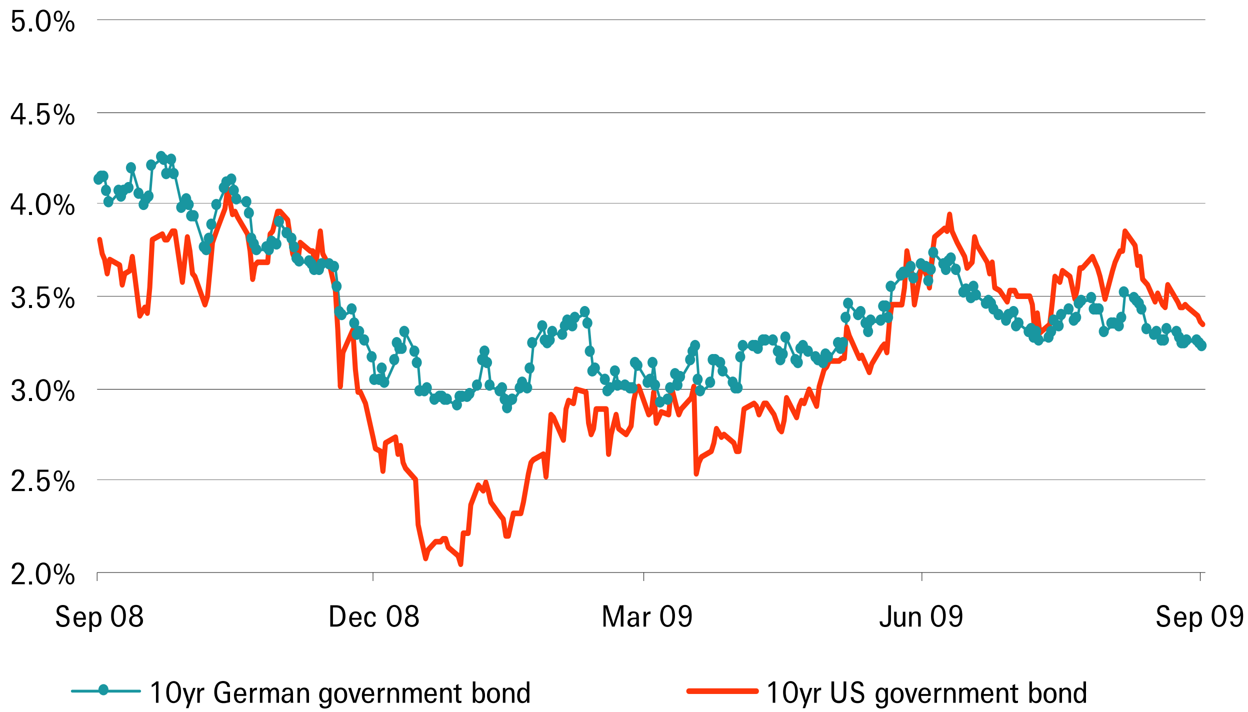

Source: Bloomberg

***Capital markets recovered forcefully already***

Swiss Re

# What do capital market improvements mean for insurers?

## When will rates on government bonds go up?



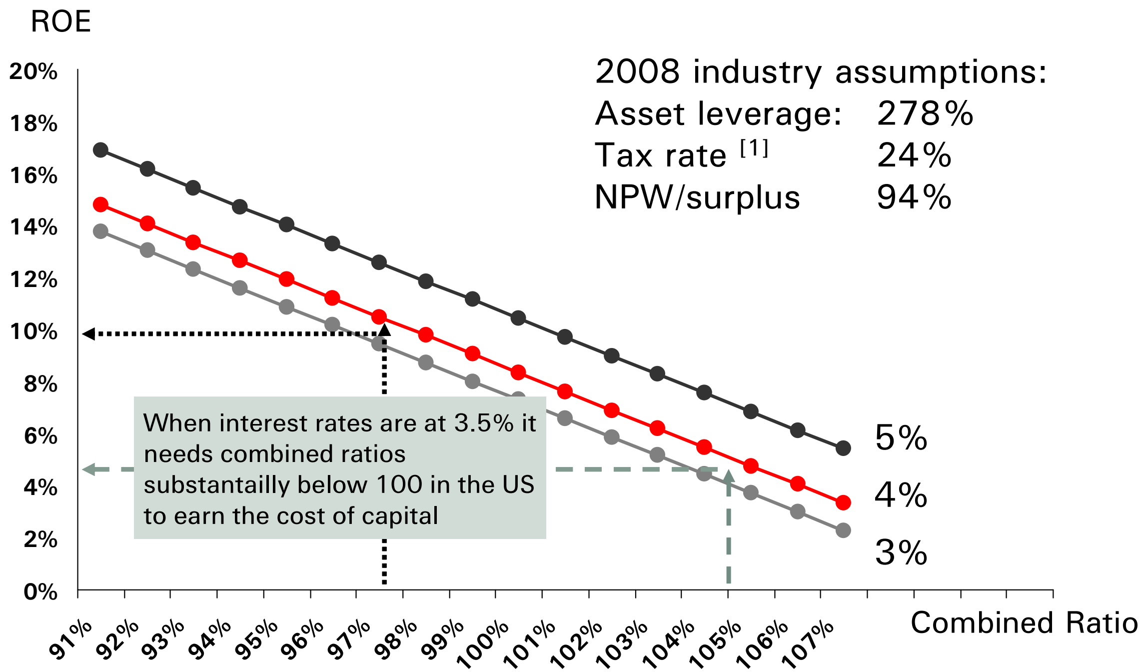

***The expected rise in interest rates is an accounting not an economic issue for insurers***

GIRO
Edinburgh, 7.10.09

# Rate development in non-life insurance

Swiss Re

## Relationship between combined ratio and profitability for different interest rate levels (US P&C market)




Sources: A.M. Best, estimates by Economic Research & Consulting.
[1] based on 1H08 effective statutory tax rates.
[2] 9M08 total investment yield was 3.0% and CR was 105

***Insurance rates don´t reflect the low interest rate development***

Swiss Re

# Summary

- In a systemic crisis many markets fail to operate in an orderly manner
- The management challenges in a crisis differ totally from those in “normal” times
- The challenges ahead are recapitalisation, coping with low interest rates and soft markets