

Insurance and the economic downturn: Forces at work



Dr Kai-Uwe Schanz, Principal Partner of Dr Schanz, Alms & Company AG, Zurich, delves into the implications of the current economic slump on the insurance sector.

Except for a few spots of resilience, such as some Gulf emirates, the world is mired in the worst recession for decades. Excesses in credit markets caused a downward spiral whose pernicious effects have fully translated into the real economy: private consumption is anemic, non-public investment activity is slowing markedly and international trade is contracting even more sharply. The economic downturn is adding further to the woes of the financial sector as loans turn sour and default rates for corporate bonds increase. What are the implications for the insurance sector, a core element of the financial services industry?

Pressure on revenues

In times of economic distress, demand for insurance cover is set to fall. As private consumption contracts, so does demand for motor and health insurance. As investment activity recedes, there are less factories and major construction projects to insure, depressing the engineering and property lines of business. Transport and credit insurers are negatively impacted by slumping volumes of international trade. Life insurers have to contend with sharply dropping sales of unit-linked products as policyholders shun investment risk.

On the other hand, there are powerful forces which support insurance demand in testing times. For example, most property & casualty policies are non-discretionary. In most jurisdictions, you need third-party motor liability insurance. The same is true for workers' compensation policies or insurance linked to residential mortgages. Another supporting factor is a general increase in risk aversion among households and firms. In times of uncertainty, insurance policies are usually not the first expenses to be slashed. Insurance demand, therefore, should prove more resilient than GDP in general.

As far as rates are concerned, two conflicting effects can be discerned. On the one hand, prices will reflect the reduced level of economic activity and insurance demand directly linked to it. On the other hand, rates will be supported by the relative resilience of insurance demand due to the supporting factors mentioned above. Even more important, rates are likely to be boosted by the evaporation of excess capital as credit and other investment losses are taking their toll on insurers' balance sheets. The turmoil on financial markets is expected to strengthen underwriting discipline and technical pricing commensurate with risk.

Uncertain impact on claims

A similarly complex situation exists in the area of claims. On the one hand, a number of behavioural changes tend to drive claims up in times of recession. Crimes, ranging from minor insurance fraud to arson, usually rise. In addition, individuals and companies tend to become more

litigious. And credit insurers face severe losses as bankruptcies spiral.


On the other hand, claims tend to decrease in line with economic activity. For example, people drive less and the number of accidents in the construction and manufacturing sectors decline.

The spectre of further investment losses

All in all, most insurers should weather the crisis' impact on their core business of risk underwriting as both premium volumes and claims are unlikely to change dramatically in either direction. This is not true for asset valuations. As major investors in all asset classes, insurers are set to suffer until the current crisis recedes. Further losses from "toxic" credit products seem to be inevitable. More worryingly, given the grim prospects for the global economy, there is the spectre of a sharp deterioration of insurers' "non-toxic" investments such as non-subprime residential and commercial mortgage-backed securities and corporate bonds.

However, it is not all doom and gloom. Unlike banks, insurers are able to hold their investments to maturity. There is no need for fire sales at depressed prices. No doubt, write-downs are painful as they may bring capital adequacy and solvency ratios to critical levels. On the other hand, there still remains the potential of (partial) future recoveries.

On balance

Compared with other sectors, the insurance industry is expected to sail relatively smoothly through the current economic downturn. Rates will hold firm as the crisis has wiped out the sector's excess capital. Overall revenues should remain robust even if insured exposures decline in line with the economy as a whole. Realised and unrealised investment losses will continue to bite, but they are not expected to have crippling effects as fire sales of assets are not on the agenda of an industry whose business model is distinctly different from the banking sector's. 

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