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Part 1: International market conditions and Swiss insurance companies

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Unofficial translation

Ladies and Gentlemen

“Sailing turbulent waters” is the motto of this year’s annual press conference of the Federal Office of Private Insurance (FOPI), which I have the honour to welcome you to. Today, we shall be presenting to you our activities for 2007, a year where rapidly changing market conditions prompted us to re-examine our regulatory objectives and supervisory approaches. The accompanying Annual Report will provide you with an overview of the supervisory activities carried out by FOPI in 2007.

In the first part of this presentation, I shall describe international market conditions and indicate how Swiss insurers have fared under these conditions based on our survey findings. I shall also draw a comparison between this crisis and the one that took place in 2001 and 2002. In the second part of this presentation, Mr Schnieper will go over these findings and share with you the results of field testing of the Swiss Solvency Test (SST). In the third part, I shall comment on the current challenges affecting supervision of the insurance market. Finally, we shall take a look at the new Swiss Financial Market Supervisory Authority (FINMA).

International market conditions

Allow me to begin with a brief overview of the international market conditions encountered in 2007. The first half of the year was mostly marked by optimistic sentiment as financial markets continued steadily upward. The trend was sustained by very strong corporate earnings and a favourable economic climate. Towards the middle of the year, news reports started coming in from the US about problems on the subprime mortgages market and related securitisation of debt. The first write-downs came shortly afterwards. Initially it was the specialised banks, but then other banks, and a few companies started following suit. The number of companies affected by the crisis continued to rise steadily to year-end.

In the final months of 2007, the US subprime crisis was having noticeable effects on some insurance companies including bond insurers. The insurance companies affected were those that had made the investments in the hopes of earning higher yields by taking greater risks. When the market took an alarmingly different turn, they were forced to write down or even write off completely the value of their investments. Other insurance companies affected included those that had diversified their activities beyond typical insurance as such.

At the heart of all of this mayhem were products and derivatives structured for use with subprime loans and mortgages. While the subprime crisis led to liquidity shortages, subsequent interest rate fluctuations on various markets had a greater impact. The worst damage occurred on the stock market, where prices declined sharply and then fell below support levels in the first quarter 2008. We still do not know the extent of damage to expect from asset-backed securities, structured products, funds or similar investment structures.

How have the supervised insurance companies in Switzerland fared? We examined the situation of Swiss-based companies, which includes Swiss companies, subsidiaries of foreign-based companies and companies managed in Switzerland with operations abroad. We took into account both their assets (i.e. investment categories used to cover tied assets) and liabilities (i.e. share capital and Solvency I criteria). Since we are only now in the process of introducing Solvency II criteria and the Swiss Solvency Test, we are unable to determine the latest situation as far as insurance company share capital and stress resistance are concerned. We do, however, have a clear picture of the prevailing trend in this area.

FOPI survey of exposure to asset-backed securities

Already in August 2007, and again in November 2007, FOPI sent a survey to selected insurance companies to determine the extent of their investment exposure. The insurance companies were asked to indicate the positions that they:

- had directly taken in mortgage-backed subprime loans on the US market;
- indirectly taken positions in the subprime market through investments in structured products or hedge funds, funds of hedge funds, derivatives, mutual funds as well as other asset-backed securities;
- Had taken in US subprime loans or investments through credit insurance, directors & officers liability insurance or guarantees and similar instruments.

The insurance companies taking part in the survey were also asked to indicate what impact the crisis has had on their earnings and liquidity, as well as any other consequences.

The survey revealed that Swiss-based insurance companies did not have any real direct exposure to the subprime loans and mortgage business. In terms of indirect exposure through funds, credit derivatives, asset-backed securities in general and other structured products with subprime components, only a few insurance companies had taken sizeable positions. However, the average exposure in these cases did not exceed 1% of the tied assets. Insurance companies, like other market participants, have been affected by the current turbulence on the various markets, particularly the stock market. However, we did not observe any noticeable risk of liquidity shortage.

In 2007, only one reinsurance group, Swiss Re, was highly impacted by the subprime mess. The posted losses came from credit derivatives, which are financial instruments that enable credit risk to be transferred to third parties. Indirect exposure arose when these instruments included securitised mortgage loans. In the particular case of Swiss Re, accounting rules required the value of these credit derivatives to be re-adjusted to reflect their market value. This resulted in a write-down and a book loss.

In addition to analysing the actual financial transactions, we also focused our attention on Swiss Re’s internal risk management system to determine responsibilities and procedures.

FOPI survey of exposure to capital losses on the stock market

After the meltdown in share prices in January 2008, FOPI contacted all supervised Swiss-based insurance companies and Swiss-based subsidiaries of foreign insurance companies to determine share capital, solvency and tied assets. The reference date chosen for the survey was 22 January 2008, with the SMI having closed at 7488 that day.

This survey showed that the early 2008 drop in prices on financial markets meant that insurance companies had less share capital than they did at the end of 2007. However, even on 22 January 2008, the insurance companies met Solvency I criteria and had enough assets set aside in their reserves to fully cover their actuarial liabilities. In particular, life insurance companies fully met the 100% minimum reserve requirement to cover their policyholders' fully reinsured pension capital. Subsequent verification in March and April confirmed that this situation has not changed.

On the whole, it can be said that while the Swiss insurance industry as a whole is quite robust, the continued uncertainty on the market does not exclude the possibility of further write-downs from individual insurance companies or other possible effects. The FOPI will therefore continue to monitor the situation.

Comparison with the crisis years 2001/2002

Of course, it is interesting to see how the current situation compares with the crisis years 2001 and 2002: Generally speaking, insurance companies today are much better capitalised than they were back in 2001/2002. Over the past few years, many insurance companies have been able to recapitalise and accumulate retained earnings. This has served to strengthen their financial situation and therefore their ability to weather the greater volatility of their investments. In addition, insurance companies also considerably reduced the proportion of shareholdings in their overall investment portfolio.

The challenges faced during the crisis years 2001 and 2002 were full of lessons. Specifically, insurance companies realised that they needed to do the following:

- Focus clearly on making their core business profitable, using their own insurance products rather than adopting conglomerate strategies;
- Remove risks from the balance sheet;
- Increase share capital through recapitalisation and earn targeted returns. The resulting growth was further sustained by a multi-year stretch where – with only a few exceptions – there were relatively few natural disasters or other major claims;
- Reduce the proportion of shares in the overall portfolio and use hedging instruments to reduce risk even further.

By taking these steps, many insurance companies were able to post very handsome profits in 2007 despite unfavourable market conditions. They were also able to pass some of these profits down to shareholders or consider this possibility.

Ever increasing competition

Despite the observed robustness, the Swiss insurance industry is not out of the woods yet. First of all, there is still some uncertainty as to what impact declining interest rates and an economic slowdown will have on earnings potential and growth in premiums. Secondly, insurance markets are becoming increasingly exposed to competition. Switzerland once again felt the heat of very intense international competitive dynamics with the acquisition of Converium Holding AG by the French company SCOR S.A. At the same time, insurance companies need to adapt both life insurance and non-life insurance conditions to the changing needs of their customers. This requires insurance companies to be highly innovative and find ways to optimise their costs.

Growth is an objective for many insurance companies, which naturally increases competitive pressures. New acquisitions bring new players and new strategies to the market. In addition, – and this will have an impact on longer-term growth – insurance companies have considerable capacities available, partly due to the steady growth of the previous years, partly resulting from the relatively low number of claims. There have been, however, growing signs of recession in the United States, which could adversely affect premium intake.

The downward pressure on premiums should come as no surprise. After all, similar cyclical developments have regularly been seen in the past. Insurance companies will therefore need to show discipline and caution when underwriting their actuarial prices. They will also need to show discipline and caution when adding to their actuarial reserves. In other words, discipline and caution will ensure that tomorrow’s problems are circumvented before they have the chance to develop.

All things considered, while insurance companies have had to deal with the current turbulence, they have thus far been able to absorb the financial blows. Only a few insurance companies ended up having to write-down the value of their investments due to their greater credit risk exposure. On the whole, the insurance market has remained stable in a shaky environment.