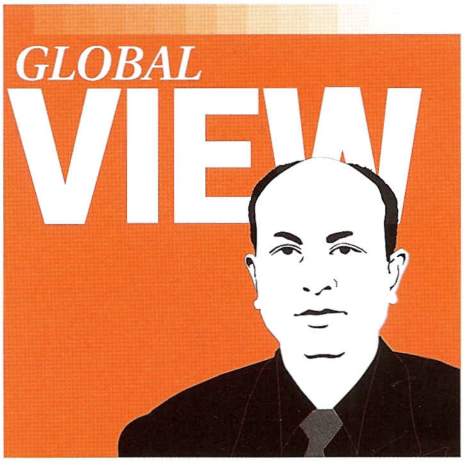

DARK CLOUDS AHEAD

Manoj Kumar considers the impact of recession on the insurance industry

Insurance companies traditionally have thrived more on investment income than core underwriting business. Competitive pricing and below-par risk rating have been protected by shrewd investment decisions. The current global recession and the consequent economic crisis has put a lid on this manoeuvrability. Falling prices in the real estate sector and nose-diving stock markets have already depleted shareholders' equity and moved the investment portfolio of insurance companies in the red zone.

There are several issues that need to be debated. Where does the insurance industry stand today amidst the current crisis? What does the future hold for the insurance industry? Can it sustain itself on underwriting results alone? How deep would the investment losses impact the balance sheet and consequential stability of the companies? There are no straight answers, yet indicators and pointers provide an overview of the situation.

Current scenario

Insurance industry follows closely the fortune of the financial sector and is directly impacted by the movements at the macro-economic level. Economic growth spurs insurance activities and a recession creates manifold problems for the insurance industry. Recession is an outcome of a slowdown in the economy and is evidenced by successive periods of negative growth in production.

The current recession actually started in late 2007 when the subprime crisis reared its ugly head though manifestations which became visible only in 2008. Several significant casualties have been reported, e.g. AIG, Lehman Brothers, Washington Mutual, Merrill lynch, Citigroup, Freddie Mac, Northern Rock, Bradford & Bingley and many others have either failed or are in bad shape due to severe losses. This situation has led to liquidity crunch worldwide and cash flow has dried up. Consumer confidence is shaken and the demand for products and services are at a low level.

Cause-effect on insurance industry

Unlike banks that were dumbstruck by the end of the third quarter in 2008 due to the unfolding saga of financial crisis, insurers have shown rather remarkable resilience and in all probability would be declaring year-end results on a positive note. The first nine months of performance may see them through despite massive investment losses in the last quarter of 2008. This situation however is short-lived and insurers are bound to feel the heat sooner rather than later.

New construction and infrastructure projects have dried up and ongoing projects have been stalled due to inadequate cash injection in the market. Banks are not releasing installments to firms even on limits, which were agreed prior to this crisis. This has impacted the engineering class of business in the insurance sector. Inquiries for CAR (Contractors' All Risks), EAR (Erection All Risks), Machinery Breakdown and Equipment Insurance have almost dried up in the past few months. Construction, infrastructure projects by governments and energy projects by private, as well as governments have either been shelved or delayed and the insurance industry will have to live without large premiums from the project insurance for some time.

Continued recession shall have an impact on the property class of business too. Cost-cutting in the corporate sector may lead to reduced expenditure on insurance. Falling market prices of property shall further bring down the premium volume on property insurance. Business Interruption or Loss of Profit premiums shall go down due to reduced profit forecasts.

The life insurance sector is likely to see even bigger erosion in volumes and profits. Employee benefit schemes, workmen's compensation, medical insurance, group life and personal accident Insurance, etc are likely to take a hit. With the investment portfolio almost gone, most unit-linked policies, pension funds and other investment-backed insurance products shall show negative NAV (Net Asset Value) and consumer confidence shall further nosedive. Policy holders are already requesting cancellation of their policies in order to preserve cash in this moment of crisis. All this doesn't bode well for the insurance sector.

The retail insurance sector has similar problems. Low consumer confidence and stringent lending norms for retail customers by banks have led to reduced demand for products and services. Automobile companies are struggling to keep afloat due to negative sales growth. This directly affects motor insurance premium. The travel industry, including airline companies, is witnessing lower traffic, resulting in reduced travel insurance premium. The reduced sale of property is resulting in reduced premium income on mortgage insurance and householders' insurance.

There are other issues to ponder. The insurance industry is likely to see multiple bad moral hazard cases as depressed market conditions may lead to corporate frauds. Such situation stimulates claims on fire losses, business interruption losses and losses arising out of directors' and officers' liability litigation. Madoff and Satyam Computers are two recent examples to prove the point.

Shareholders' and regulators' role

Continued depressed market and resultant decline in premium volumes (and conse-

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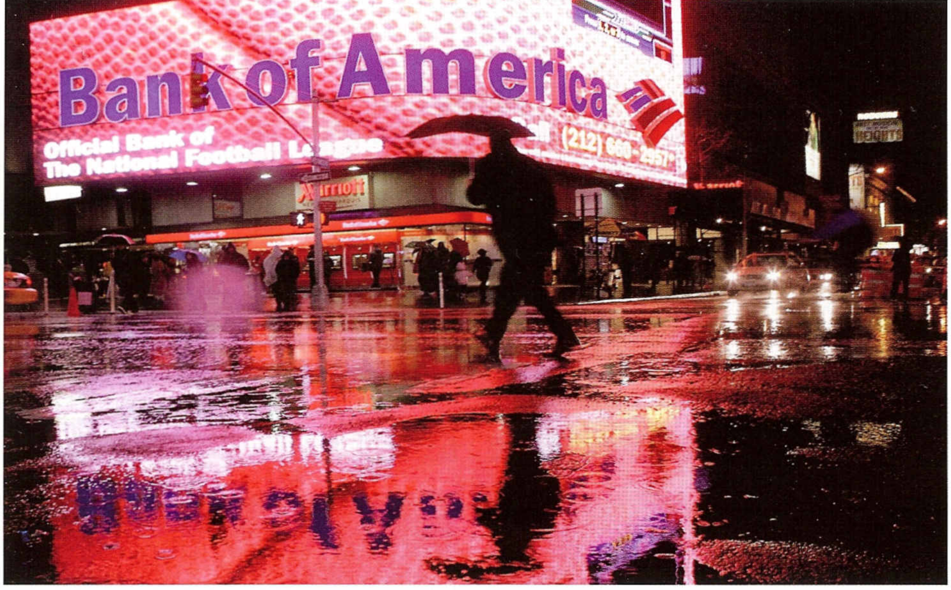

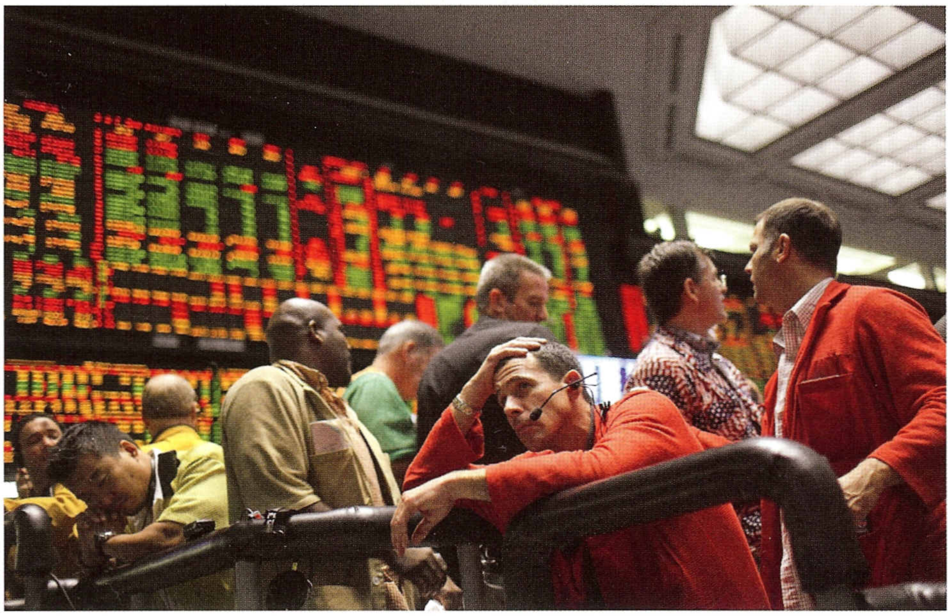

Top: *Bank of America Corp plans to eliminate 30,000 to 35,000 jobs over three years as it integrates Merrill Lynch & Co and experiences weaker business activity amid the economic recession.* **Bottom:** *Global markets plummeted after investment bank Lehman Brothers filed for bankruptcy protection, rival Merrill Lynch agreed to be taken over and the Federal Reserve threw a life line to the battered financial industry.*

quently reduced profits) is likely to put pressure on the management of insurance companies. As they struggle to satisfy their shareholders by providing similar returns as in the past, this could lead to rate cutting, unbalanced portfolio and compromised underwriting. A prudent board and shareholders of the insurance companies would do well to advise the management to concentrate on quality rather than volume business so that bottom lines are at least maintained.

Regulators, have a big role to play under such extraordinary circumstances. Supervision needs to be thorough rather than routine. Emphasis should be on ratios and reserves rather than procedural issues. Solvency ratio and liquidity ratio must remain healthy and technical and other statutory reserves must be robust. An eye on the reinsurance market and regular advisory would supplement the supervisory efforts. For countries where regulation is non-existent or weak, the respective governments have to step in before it is too late. The world has understood the significance of solvent insurance industry by witnessing the way the US treasury handled the AIG crisis. Failing banks followed by failed insurance companies can spell doom for the entire economy.

Impact on gulf markets

The Gulf was considered to be immune to the global meltdown until the recession actually hit. Falling oil prices have taken the shine off the GCC's booming economy. There is a big question mark over the sustainability of petrol-based economies as new energy projects have become non-viable, thanks to rock bottom oil prices. Traffic suddenly looks normal on Dubai roads, real estate prices have halved across GCC states, new projects and tenders are delayed in Qatar and OPEC countries are making one production cut after another.

Several announced projects have been cancelled and that has resulted in the termination of various insurance policies. The ripple effect has just begun and is set to further crystallize in 2009. The Middle East insurance market growth of 12 per cent in 2007 (Swiss Re Sigma 5/2008) may be sustained in 2008 in terms of volume growth, although profitability is bound to decline.

Weathering the storm

Hard times must be negotiated with a changed business strategy. Competition should give way to collaboration among insurance carriers. The events in recent months have shown that completely free economy and unhindered competition needs to be moderated. Governments across the world have stepped in to support or acquire various ailing corporate to provide solidity in the financial markets. Insurance companies need to take a cue and concentrate on really good underwriting before it is hit by its own "subprime". New products should be developed and niche markets need to be looked at rather than fighting for the same space. Exploiting Bancassurance and consolidating the existing book of business could be some of the options.

There is an eerie silence across the insurance industry globally as the economic outlook remains uncertain. 2009 is bound to pose a threat of survival for many insurers and reinsurers. The last thing the global economy needs at this stage is the failure of insurance setup. Economists are predicting return to normalcy by the end of 2009. Even if this optimism actually fructifies, the benefits can only accrue in 2010. Collaboration and consolidation is the name of the game till such time.

THE AUTHOR

Manoj Kumar has more than 22 years' experience in insurance and banking. He is working as executive manager with Doha Bank Assurance Company in Qatar and has worked for various insurance companies and banks in India, UAE and Qatar