



Impact of S&P Downgrade of U.S. Sovereign Debt **On U.S. Life & P&C Insurers** (August 8, 2011)

On Friday, August 5th, Standard and Poor's downgraded the U.S. *long-term* sovereign debt¹ from AAA (highest) to AA+ (2nd highest). This marks the first time that U.S. sovereign debt of any sort has been rated below AAA by any of the major public rating agencies. The government's *short-term* debt ratings remain A-1+ (highest).

S&P's downgrade reflects the agency's opinion that:

- The government's fiscal consolidation plan "falls short of what would be necessary to stabilize the government's medium-term debt dynamics."
- The "effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges."
- The country faces difficulty bridging the gulf between the major political parties over fiscal policy, making the agency pessimistic about the capacity of Congress and the Administration to leverage their recent agreement into "a broader fiscal consolidation plan that stabilizes the government's debt dynamics."

The outlook on the government's long-term rating is negative and could be further lowered within the next two years if S&P sees "less reduction in spending than agreed to, higher interest rates, or new fiscal pressures during the period result in a higher general government debt trajectory" than currently assumed by the agency's base case.

S&P, when spelling out their downgrade, speaks of the current "contentious and fitful (political) process" surrounding the fiscal consolidation plan, "political brinksmanship", U.S. governance and policymaking becoming "less stable, less effective, and less predictable," "political bargaining chips in the debate over fiscal policy," and differences between political parties being "extraordinarily difficult to bridge."

In contrast, S&P writes that it views the U.S. government's "other economic, external, and monetary attributes, which form the basis for the sovereign rating, as broadly unchanged." *In short, this downgrade is all about the major political parties' inability to make tough long-term decisions about sustainable and on-going fiscal policy.*

S&P discusses three scenarios and their impact on future long-term sovereign ratings actions: base case, upside, and downside. Below are the basic assumptions of each. The table on the following page outlines S&P's projection of U.S. debt to GDP burdens under each scenario.

- Base case scenario:
 - 2001 and 2003 tax cuts remain in place,
 - Real GDP growth of 3%, consumer price inflation of 2%,
 - Current projected spending cuts of approximately \$2.4 trillion,
 - **Negative Outlook remains in place.**

¹ Long-Term Debt for S&P refers to any instrument with maturities of more than one-year.

- Upside scenario:
 - Higher revenue with the expiration of the 2001 and 2003 tax cuts,
 - Same macroeconomic and spending cut assumptions as in base case,
 - Current projected spending cuts of approximately \$2.4 trillion,
 - **AA+ Long-term rating revised to stable from negative**

- Downside scenario:
 - 2001 and 2003 tax cuts remain in place,
 - Real GDP growth of 2.5%, consumer price inflation of 1.5%
 - 2nd round of spending cuts (approximately \$1.2 trillion) does not occur,
 - Somewhat higher nominal interest rates for U.S. Treasuries (50-75 basis point rise in 10 year Treasury rates).
 - **Possible further downgrade to AA (3rd highest) long-term debt rating.**

S&P Debt to GDP Projections Three Scenarios			
<i>Scenario</i>	<i>Net General U.S. Gov't Debt to GDP</i>		
	<i>2011</i>	<i>2015</i>	<i>2021</i>
Base Case	74%	79%	85%
Upside	74%	77%	78%
Downside	74%	90%	101%

S&P concludes by comparing the current U.S. long-term ratings to other “relevant peers” that continue to carry their AAA rating: Canada, France, Germany, and the U.K., with the conclusion that the “U.S.’s net public debt is diverging from the others,” and that by 2015 or earlier the net public debt burdens of these other countries will begin to decline while those of the U.S. will continue to climb.

Impact on U.S. Insurers

We discuss below this downgrade’s potential impact to U.S. insurers – life, property & casualty, and health – from four different angles:

- 1) Direct impact on U.S. insurers’s ratings
- 2) Impact of potentially higher capital charges
- 3) Potential impact on interest rates
- 4) Impact of adverse economic growth/double dip recession

The first and second angles deals directly with rating and capital charge ramifications of this downgrade, while the other angles revisit points of discussion that we have often covered in past releases or analyses for clients.

1. Direct Impact on U.S. insurers ratings

The most immediate impact on U.S. insurers, seen today, is the downgrade of AAA rated companies to AA+. This is based on S&P’s stated policy that “the ratings on U.S. insurers are constrained by the U.S. sovereign credit rating because their businesses and assets are highly concentrated in the U.S.”² The same reasoning does not hold for either Moody’s or Fitch, which have stated that individual companies can have a rating higher than their corresponding country’s sovereign debt rating.

² See S&P’s release: “Outlooks on Five U.S. Insurance Groups Revised to Negative from Stable Following Sovereign Outlook Revision” April 18th, 2011

Based on the aforementioned policy, S&P placed five U.S. insurance groups with AAA ratings on a negative outlook on April 18th, 2011, upon their revision of U.S. long-term debt to negative. These insurers include: Knights of Columbus, New York Life, Northwestern Mutual, TIAA-Cref, and USAA. While S&P made no mention of AAA-rated P&C carriers, USAA has two insurers followed by ALIRT with AAA ratings: United Services Auto Association and USAA Casualty Insurance Company. ALIRT follows no other P&C companies rated AAA by S&P.

This morning S&P downgraded each of these carriers to AA+ (2nd highest). ***It is our opinion that this one-notch downgrade of these companies does not alone reflect any material deterioration in the companies' financials and our proprietary qualitative credit ratings on the carriers have not changed as a result of S&P's action. Furthermore, this one-notch downgrade does not directly impact the current ALIRT Score for any of the companies within these groups.***

In fact, ALIRT's analytical practice – which concentrates more attention on the stand-alone financials of individual insurers vs. their holding groups – has demonstrated that the relative financial strength of individual legal entity insurers can at times vary greatly from the perceived financial strength embedded in public ratings. In short, today's insurers downgrades reflect no change to the underlying reported financials of these companies.

2. Impact of Potentially Higher Capital Charges

As for any direct impact on risk-based (or other) charges to insurer investments, it is telling that the NAIC today issued the following statement in regard to the downgrade of the U.S. Credit Rating:

"There is no impact on insurer investments in U.S. government and government-related securities from the actions recently taken by the rating agencies. Risk-based capital and asset valuation reserves are unaffected. State insurance regulators and the NAIC will consider changes to our regulatory treatment if it becomes necessary in the future."

In short, the downgrade of any long-term U.S. sovereign debt to AA+ does not impact risk-based capital charges (currently 0) given that this rating remains comfortably within the "Class 1" designation (AAA to A-). Of course, the NAIC could decide to subject downgraded sovereign debt to risk-based capital charges, though these charges would likely be negligible.

However, S&P stated that it plans to release today reports on other asset classes, including municipal bonds. It is difficult to predict just what municipal bonds may be vulnerable to knock-on downgrades of the country's sovereign debt, ***but certainly municipal bonds that are more exposed to direct federal spending may be vulnerable as the federal government seeks to cut back on expenditures.*** Downgrades of municipal bonds below A- (Class 1) or below BBB- (Class 2) could impact property & casualty risk-based capital ratios, given that P&C insurers are large holders of municipal debt.

3. Potential Impact on Interest Rates

As for the indirect impact of interest rate movements (i.e. the free markets reaction to the downgrade), while this is a complicated and unpredictable matter – i.e. no one can predict what will happen to interest rates based solely on this downgrade – ***it appears that U.S. sovereign debt in the current capital market downswing has maintained its historical role as a "risk-free investment."*** That is, as investors have fled riskier assets, U.S. Treasury bond prices have risen (and interest rates fallen) with increased demand for these investments.³ If this remains the case, insurer portfolios would actually benefit from unrealized capital gains on these holdings as values rise. Other bond holdings (e.g. corporates, structured securities, government sponsored entities,

³ For example, with the S&P down over 5% in midday trading today, 10 year Treasuries have rallied, with yields at historically lows of approximately 2.35%.

etc.), however, could face substantial unrealized losses and potential impairments in such a stressed capital market environment.

Of course, lower interest rates traditionally have an adverse impact on life insurer products and investment yields. While unrealized capital gains are positively impacted by lower interest rates on fixed income assets, the very important portfolio yields of insurers could potentially be adversely impacted by low interest rates. Because the profitability of many insurance products depends on crediting spreads, the narrowing of these spreads (lower investment yields vs. contractual/regulatory crediting rate floors), can significantly impact earnings and hence capital positions.

4. *Impact of Adverse Economic Growth/Double Dip Recession*

As hinted at in the discussion above, the impact of S&P downgrade of U.S. sovereign debt to U.S. insurers is really a side-show, with no meaningful *direct* manifestations. However, this downgrade, as a significant expression of worldwide financial uncertainty, is extremely meaningful and could mark the onset of more troubled economic conditions ahead.

In short, the downgrade is largely the reflection and not the cause of on-going financial turmoil in both global economies and capital markets. It is precisely this uncertainty and the possibility of equity and credit market retrenchment/double dip recession that has the greatest impact on U.S. insurers.

More specifically, lower economic growth and/or equity markets impact insurers in the following way, which could impact insurers' ALIRT Scores and/or credit ratings.

- Lower equity markets could:
 - Result in direct investment losses for insurer's equity holdings (including on some Schedule BA assets), potentially hurting earnings and capital positions;
 - Force variable annuity writers to post higher reserves for embedded secondary guarantees, reversing the positive impact to earnings and surplus of reserve releases over the past two years;
 - Result in lower separate account asset values and thus lower fee income based on these assets (management and investment fees), hurting earnings;
 - Result in lower sales of variable annuity policies, putting pressure on insurers to bring expenses into line with revenue or face lower margins;
 - Cause potential buyers of all insurance products to feel less wealthy and thus defer purchases;
 - On a positive note, could spur a retreat to guaranteed products, helping the sale of fixed annuities and potentially some permanent life insurance products.
- Weaker economic conditions, including a possible double dip recession, could:
 - Result in a return to investment losses in bond, direct mortgage, and equity holdings, adversely impacting insurers' investment returns and leading to weaker profitability and/or net capital losses (= lower surplus);
 - Cause buyers of all insurance products (life, P&C, and health) to feel less wealthy and thus defer purchases in a broad range of products;
 - Result in higher unemployment, impacting group life and health, property & casualty, and group medical health sales.
 - Have an especially adverse impact on property & casualty insurers if it defers a likely needed turn in commercial lines pricing, as supply for product would continue to exceed demand and insurance buyers balk at price increases.

Conclusion

The recent downgrade by S&P of the U.S.'s long-term sovereign debt rating will likely not have a serious *direct* impact on the financial profile of U.S. life, property & casualty and/or health insurers. This is largely due to:

- 1) The rationale for S&P's downgrade of the remaining AAA rated insurers; i.e., S&P was essentially forced into this downgrade by its convention of not allowing insurer ratings to exceed those of its sovereign government. Moody's and Fitch have not reacted in like manner;
- 2) The current non-impact to insurer risk-based capital charges of government securities, as these remain comfortably within the Class 1 (AAA to A-) range.

However, the *indirect* impact of this downgrade – as an expression and reflection of both present and perhaps future worldwide economic uncertainty – could have a significant impact on insurers' financial performance.

For instance, capital market reaction to this downgrade, in conjunction with negative news in other areas (European fiscal issues, unrest in the Middle East, the impact of the substantial earthquake/tsunami losses in Japan, worldwide economic retrenchment in both developed and developing countries, etc.), has contributed today to further substantial sell-offs in U.S. equity markets. As discussed, lower equity markets have a direct earnings impact on writers of variable annuities, while low interest rates (attendant upon global economic weakness) impact the investment yields/credit spreads of insurers, compressing margins. Weak capital markets also often result in net capital losses and/or credit impairments, which can lead to decreased capitalization. Lastly, weaker economic conditions impact the sales of all insurance products and could be especially damaging to the P&C market which appears to be struggling to raise pricing after seven years of soft market conditions.

In short, more than three years after the onset of the financial crisis, the macroeconomic conditions that directly impact insurers both on a revenue generation and earnings basis appear to be once again in great flux. The downgrade of the leading economic power's sovereign debt only exacerbates current global financial anxiety.

We conclude on a positive note, however, by reiterating the U.S. insurance industry's inflated but higher capital levels since the onset of the global financial crisis, macro hedges for statutory capital, continued hedging for variable annuity guarantees and other products, derisked investment portfolios and product suites, higher cash and liquidity levels at holding companies, as well as lower reliance on short term debt at holding companies. These all serve as some protection against the impact of a potential second round of serious economic and capital market deterioration.

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