Panic Spreads Through Europe's Insurance Firms

by Alexander Hartmann

As stock markets worldwide have plunged back to the multiyear lows reached in Autumn 2002, the reserves of insurance companies and pension funds across Europe have melted down below legal requirements, forcing them to sell even more stocks to limit losses for their clients. The precarious situation of those insurers and pension funds became a self-feeding spiral in the last week of January. On Jan. 27, the British Financial Services Authority (FSA), an independent body given statutory powers by the Financial Services and Market Act of 2000, to regulate the financial services business in the United Kingdom, was forced to tell "embattled life insurers" that they would be allowed to "temporarily disregard solvency requirements," according to the London *Times.*

That day, owners of insurance stocks had hit the panic button and sent the stock prices of the top European insurance firms like Allianz, Munich Re, Swiss Life, Swiss Re, ING, and Aegon down by 6% to 8%. Most dramatic was the situation in Britain, where the FTSE index on Jan. 27 fell for the 11th consecutive trading day, something that had never happened since the index was created in 1983. Of the FTSE's 100 companies, only one rose and 99 fell. London's big Prudential Life Assurance and Aviva Insurance each lost 7%.

London *Guardian* columnist Larry Elliott warned on Jan. 28 that "In the City, reports were rife that insurance companies were selling shares to shore up their shaky financial position." Concerns were that the FTSE had fallen through the 3,500 level, which FSA chairman "Sir Howard Davies has highlighted in the past as a possible flashpoint."

The Self-Feeding Spiral

The British insurance companies, like those in most nations, collect premiums from individuals or firms, and invest them in stocks, bonds, or other investment outlets. From the "booming" 1990s, most insurance companies had portfolios that were heavily weighted toward stocks. But, between December 1999 and Jan. 27, 2003, the FTSE 100 has fallen in half. As well, many property and casuality insurance companies, regardless of country of origin, suffered heavy losses in the Sept. 11, 2001 destruction of the World Trade Center buildings, and in the European floods of 2002. As of October 2002, insurance industry analysts had estimated that European insurers had lost more than $98 billion in capital over the preceding year. Through Jan. 27, the fall in stocks has wiped out further capital.

Furthermore, many insurance companies can only write policies against a certain level of reserves. If their reserve levels fall, they cannot write new policies, and may have to cut back on old policies. When they reduce the level of policies, they reduce the level of premiums they collect, and set a vicious cycle into motion.

The London *Times* was obviously strongly affected by the panic that spread in the City, reporting and commenting on events in three articles and an editorial on Jan. 28. Under its lead economic headline "Looking into the abyss," the paper wrote: "Insurers' shares dived on growing fears for their solvency and concerns that they will be forced to dump equities into a falling market. . . . As plunging markets fuelled anxieties over the threat of failure by financial institutions, the Government, Bank of England, and Financial Services Authority faced a chorus of demands for action."

According to the *Times,* the FSA told insurers to "temporarily disregard solvency requirements," to avoid selling off their stocks and worsening the crisis. The FSA further announced that "emergency contingency plans had been drawn up to deal with further market falls," but refused to outline details. Additional measures would probably not be taken "unless there was a systemic risk to financial stability." The *Times* then notes: "The Bank of England also faced calls to step in to stem the market's losses. Officials at the Bank refused to comment and said its role was purely as a lender of last resort." In his *Guardian* column, Elliott stated: "The FSA last night acknowledged that these were 'difficult and challenging times for life insurance and their policy holders.' " Elliott said that according to the FSA, "action had already been taken by the [insurance] industry . . . to preserve its solvency. It said that 5.6 bn pounds of new capital had been raised by major insurance companies and 30 bn pounds of with-profit funds [similar to mutual funds] have been closed to new business. In addition, 2.5 bn pounds has been switched out of equities into other assets, such as gilts." Likely, the Bank of England is also pumping in liquidity.

Times: Break Free-Market Rules!

Apparently, the *Times* feels this is not enough to meet this crisis. The Bank of England has to fight the "panic-spreading dragon" and bail out the British insurance and pension fund business, which owns 40% of all British stocks, demanded *Times* financial editor Graham Searjeant. In an editorial, flanked by features on historic market crashes (the 1720 "South Sea bubble," the 1845 "railway juggernaut," and the 1998 Russia, Asia, LTCM dramas), Searjeant notes that in all the previous market meltdowns, central banks stepped in to minimize losses and prevent "general panic." Searjeant recalled that in 1973 the Bank of England joined the Big Four banks' financial support group, known as the Lifeboat, which "agreed to break economists' free market rules, . . . [and] the whole notion of moral hazard, the idea that companies should pay for their own foolish mistakes, was abandoned for the duration." This is the model for today's ongoing insurance crisis, the *Times* hopes.