Box 17

EURO AREA INSURERS' DIRECT EXPOSURES TO THE STRUCTURED US SUB-PRIME MORTGAGE MARKET

The recent market turbulence created by negative developments in the US sub-prime residential mortgage market and the related uncertainty surrounding structured credit products have raised concerns about the extent and nature of euro area insurers' exposures to these kinds of investments.

Although uniform and representative data are lacking, some insurers have chosen to disclose the exposures they had to US sub-prime mortgage asset backed securities at the end of the first half of 2007, mainly to meet high investor interest. These data showed that the exposures in general were limited, on average less than 1% of overall invested assets, and that they were mostly towards high-rated investment segments (see Table).

Table Sub-prime ABS exposures of a sample large euro area insurers/reinsurers

(H1 2007)

	sub-prime exposure (EUR billions)	sub-prime exposure (% of invested assets)	sub-prime exposure rated ≥ AA (%)
ING	4.1	0.6	93
Aegon	3.3	2.3	100
Axa	2.2	0.5	91
Allianz	1.7	0.6	86
Munich Re	0.6	0.3	79
Scor	0.1	0.7	100
Hannover Re	0.1	0.5	80
Generali	0.0	0.0	100
Irish life	0.0	0.0	

Sources: Barclays Capital and Moody's.

The rather low exposures compared, for example, to some euro area banks could be explained by the fact that euro area insurers have limited appetite for high levels of credit risk. This preference can be explained by three main factors.[1] First, euro area insurers faced significant investment income losses following the turmoil in equity markets in 2000-2002. This caused a shift away from equity investments and increased the appetite of insurers for higher quality assets. Second, insurers have started to re-align their balance sheets in order to meet the requirements of Solvency II, which will entail insurers having to hold larger amounts of economic and regulatory capital for higher-risk investments and will put in place fairly tight internal

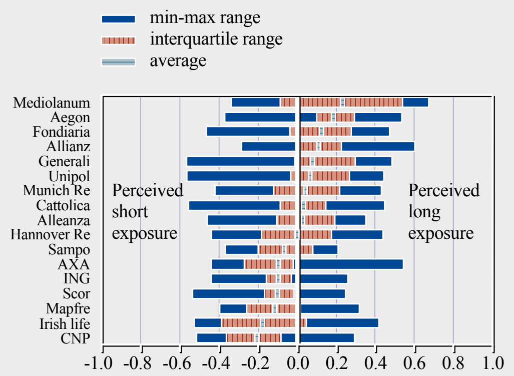
1 See Moody's (2007), "US Sub-prime Market Crisis: Direct Impact on European Insurers is Largely Limited, Second-order Effects are Likely to be of Greater Significance", August.

investment guidelines, especially for credit risks.[2] This has had the effect of reducing the appetite of insurers for higher-risk investments, such as speculative-grade fixed-income securities. Third, insurers often try to match the risk-return profiles of their liabilities and assets by, for example, aligning currency and domicile of assets and liabilities, which could explain the rather low appetite for US structured finance products among euro area insurers.[3]

The perception that the exposures of euro area insurers to the US sub-prime residential mortgage market were limited was also reflected in rather low correlations between the stock prices of insurers included in the Dow Jones EURO STOXX insurance index and the prices of indices based on US sub-prime securities (see Chart).

Chart Correlation of stock price changes of individual insurers with changes in the index of credit default swaps (CDSs) on asset-backed US sub-prime securities (AAA rated)

(1 July 2007- 20 Sep. 2007; 20-day moving window)



Sources: JP Morgan Chase & Co, Bloomberg and ECB calculations.
Note: The stock price changes of the insurers are relative to the Dow Jones EURO STOXX insurance index. The CDSs index on asset-backed US sub-prime securities is the ABX AAA (2006-2 vintage) index tranche.

Even if they have exposures, insurers are likely be less affected by losses in sub-prime securities markets than other investors because their long-term (or buy and hold) investment strategies mean that they face a lower risk of being forced to sell assets when markets are weak. Moreover, since insurers are not leveraged investors, they do not face the risk that their cost of funding positions can rise unexpectedly.

All in all, available information suggests that euro area insurers in general have limited direct exposures to structured finance products based on US sub-prime residential mortgages. Furthermore, strong financial performances during recent years and adequate capital adequacy should help those insurers which are exposed to weather any losses so that only moderate effects on the solvency of the euro area insurance sector are likely.

2 See also ECB (2007), “Potential impact of Solvency II on financial stability”, July.
3 Some euro area insurers, and in particular reinsurers, are, however, large global insurers with business activities also outside the euro area.