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Insurance, Economic Turmoil and Political Upheaval: *The Future of Risk Management in the Post-Crisis World*

Insurance Institute of London Lecture Programme
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Presentation Outline

- **The Global Financial Crisis and the New World Order**
- **Reshuffling the Global Economic Deck**
  - Finding a path to long-term growth
  - Foreign Direct Investment (FDI) and insurance exposure/demand
- **Insurance in the Age of Austerity**
  - Fiscal discipline, end of stimulus: Insurance consequences
- **Economic Threats to the Global (Re)Insurance Industry**
  - Debt crises
  - Inflation/deflation
  - Trade/Currency wars
  - Low interest rate yields
- **The Unfortunate Nexus: Opportunity, Risk & Instability**
  - Future growth is necessarily fraught with greater risk
  - Types, magnitude of risk inherent in future growth opportunities
- **Q&A**

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The Global Financial Crisis and the New World Economic Order

The Crisis Made Insurers' Path to Growth Both More Clear and More Challenging

World Economic Outlook: 2010-2011P

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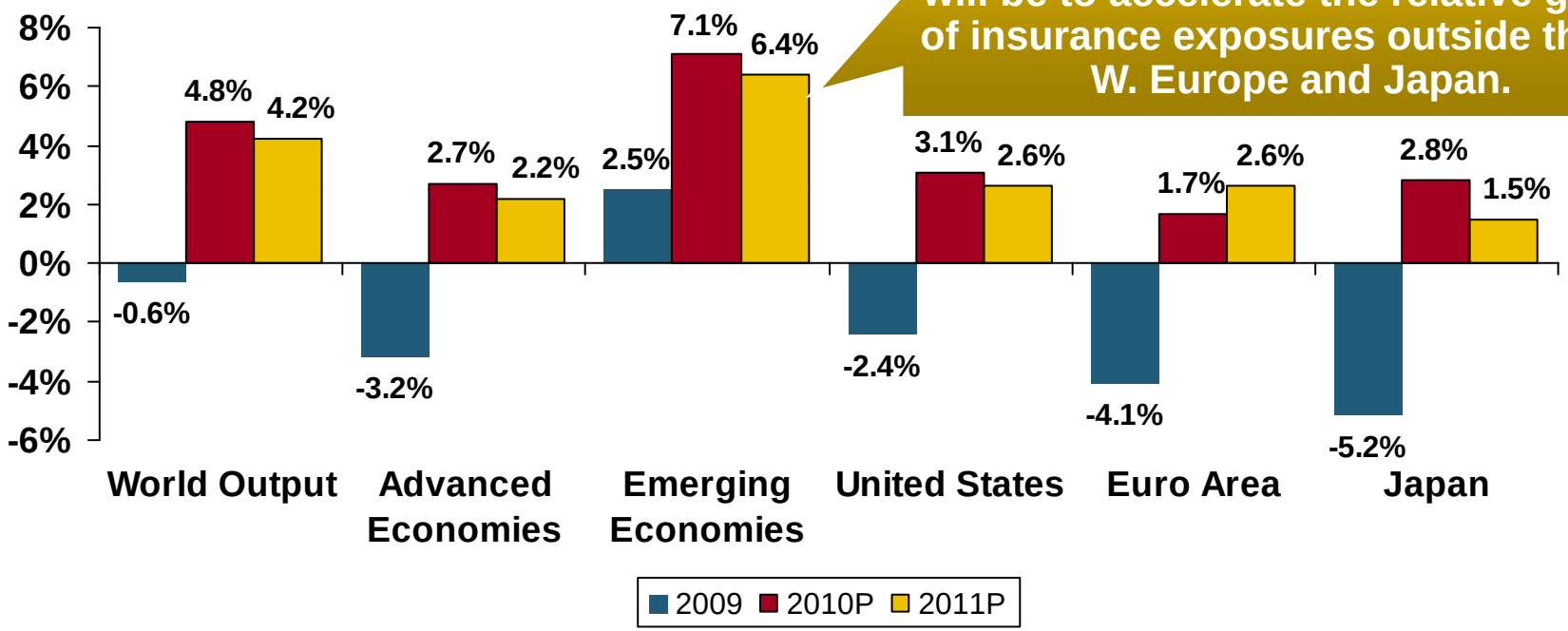
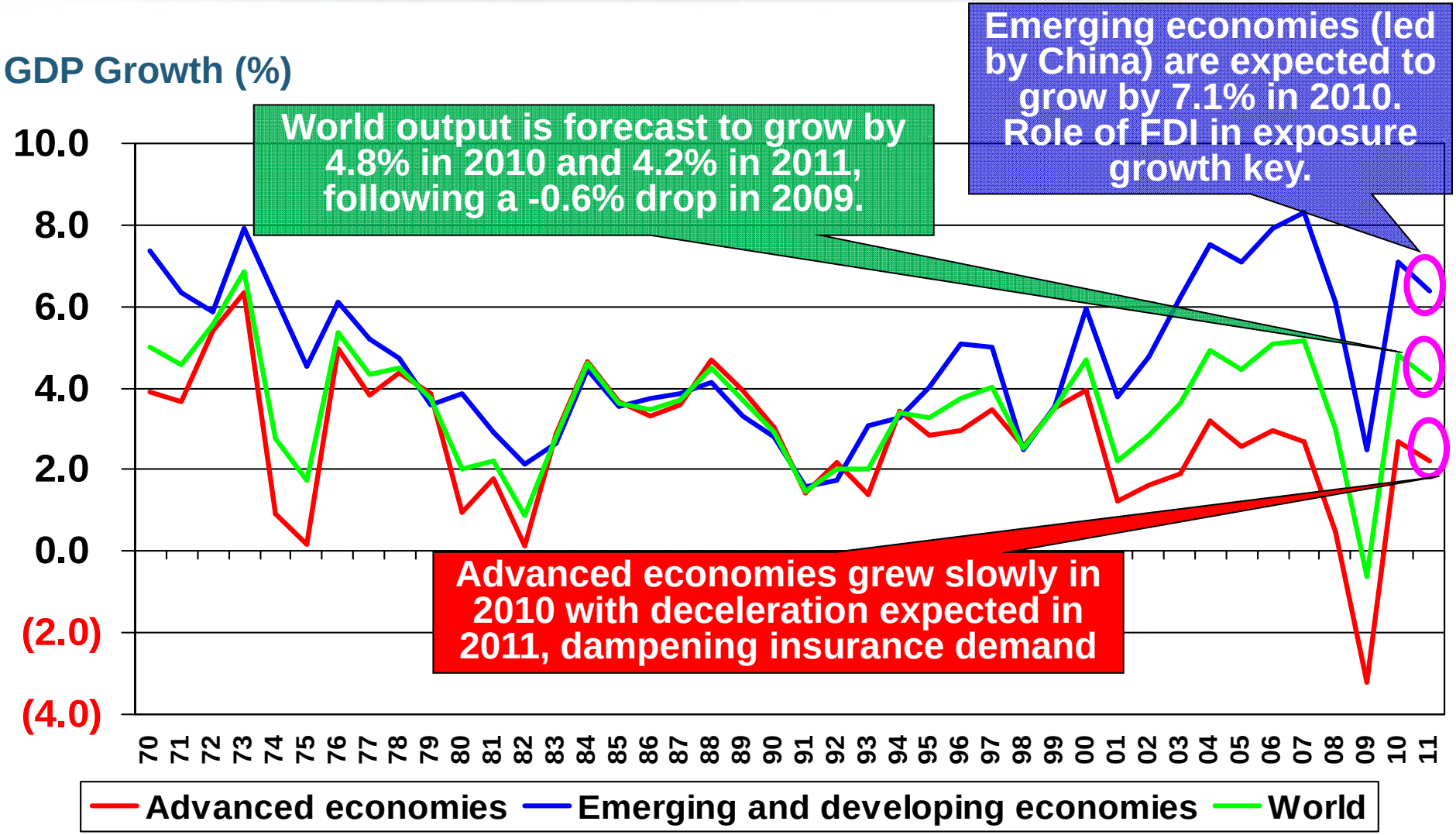
IMF says growth in emerging and developing economies will outpace advanced ones in 2010/11. The impact will be to accelerate the relative growth of insurance exposures outside the US, W. Europe and Japan.



Outlook uncertain: The world economy is recovering from the global crisis better than expected, but activity is reviving at different speeds in different parts of the world, according to the IMF. A clear set of "winners" has emerged with direct implications for insurers.

Sources: IMF, World Economic Outlook, Oct. 2010; Insurance Information Institute.

GDP Growth: Advanced & Emerging Economies vs. World, 1970-2011F



Source: International Monetary Fund, *World Economic Outlook Update*, October 2010; Ins. Info. Institute.

Global Industrial Production Rebounds From a Tailspin; Global Trade Recovering

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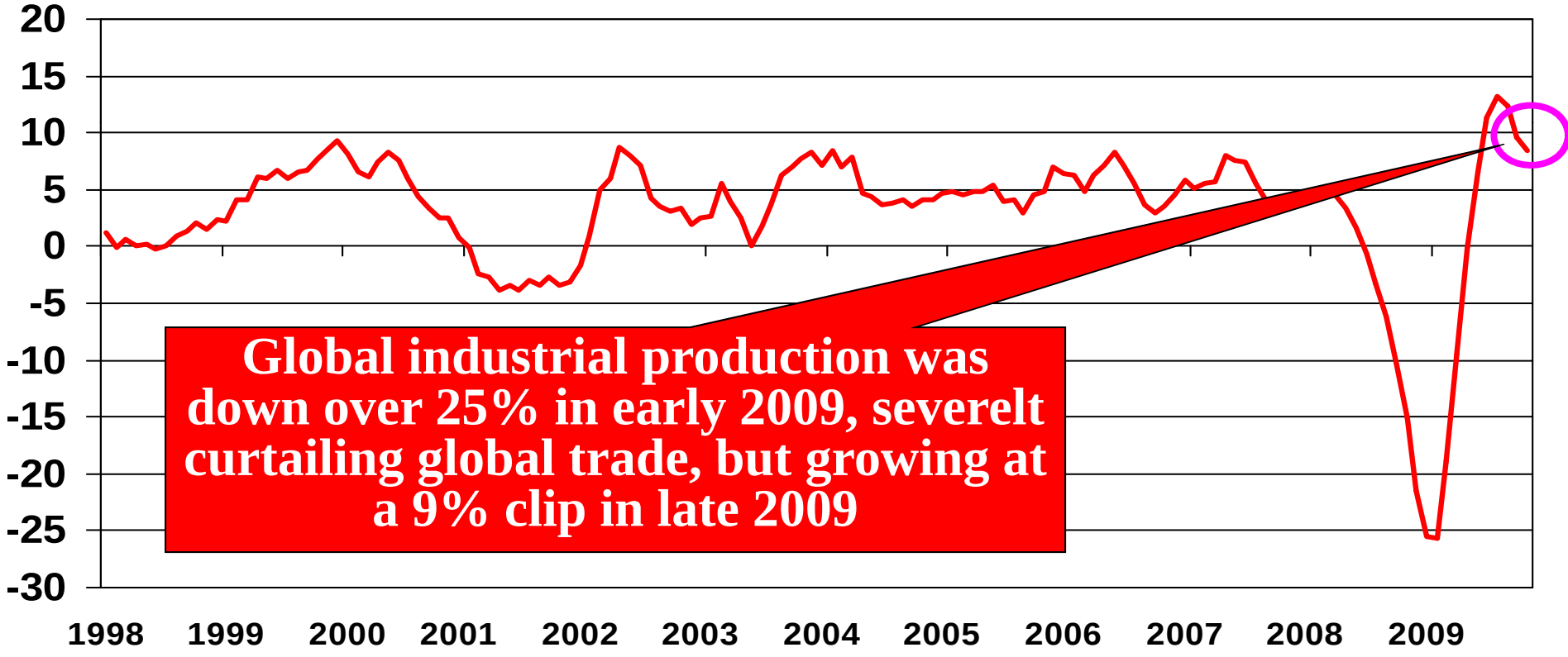
Annualized 3-Month Percent Change



Source: International Monetary Fund, *World Economic Outlook Update*, Jan. 26, 2010; Ins. Info. Institute.

Unemployment Rates for Major Global Economies, 2009-2011F

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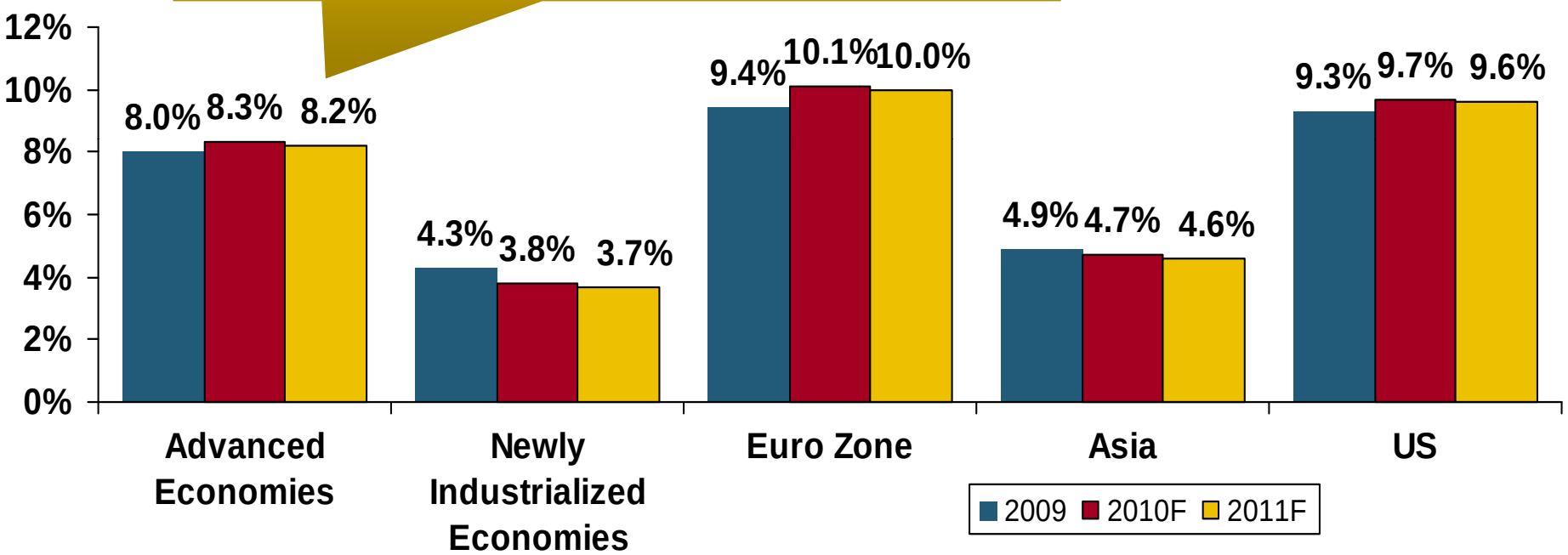
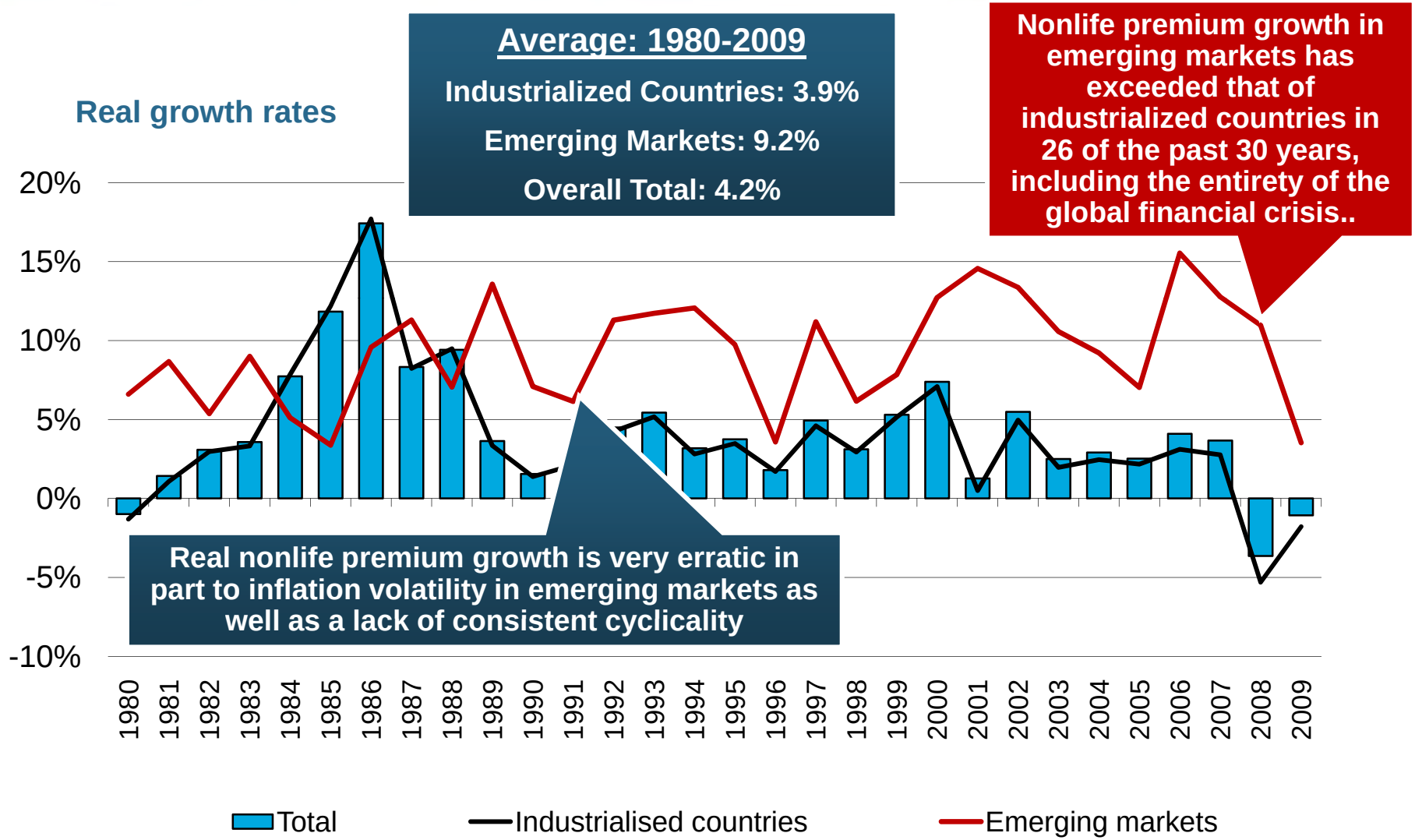
Persistently high unemployment is among the greatest obstacles to insurer exposure/demand growth (nonlife and life)



Unemployment in Advanced Economies is more than double that of Emerging Economies

Sources: IMF, World Economic Outlook, Oct. 2010; Insurance Information Institute.

Global Real (Inflation Adjusted) Nonlife Premium Growth: 1980-2009



Source: Swiss Re, *sigma*, No. 2/2010.

Nonlife Real Premium Growth Rates by Region: 1999-2008 and 2009

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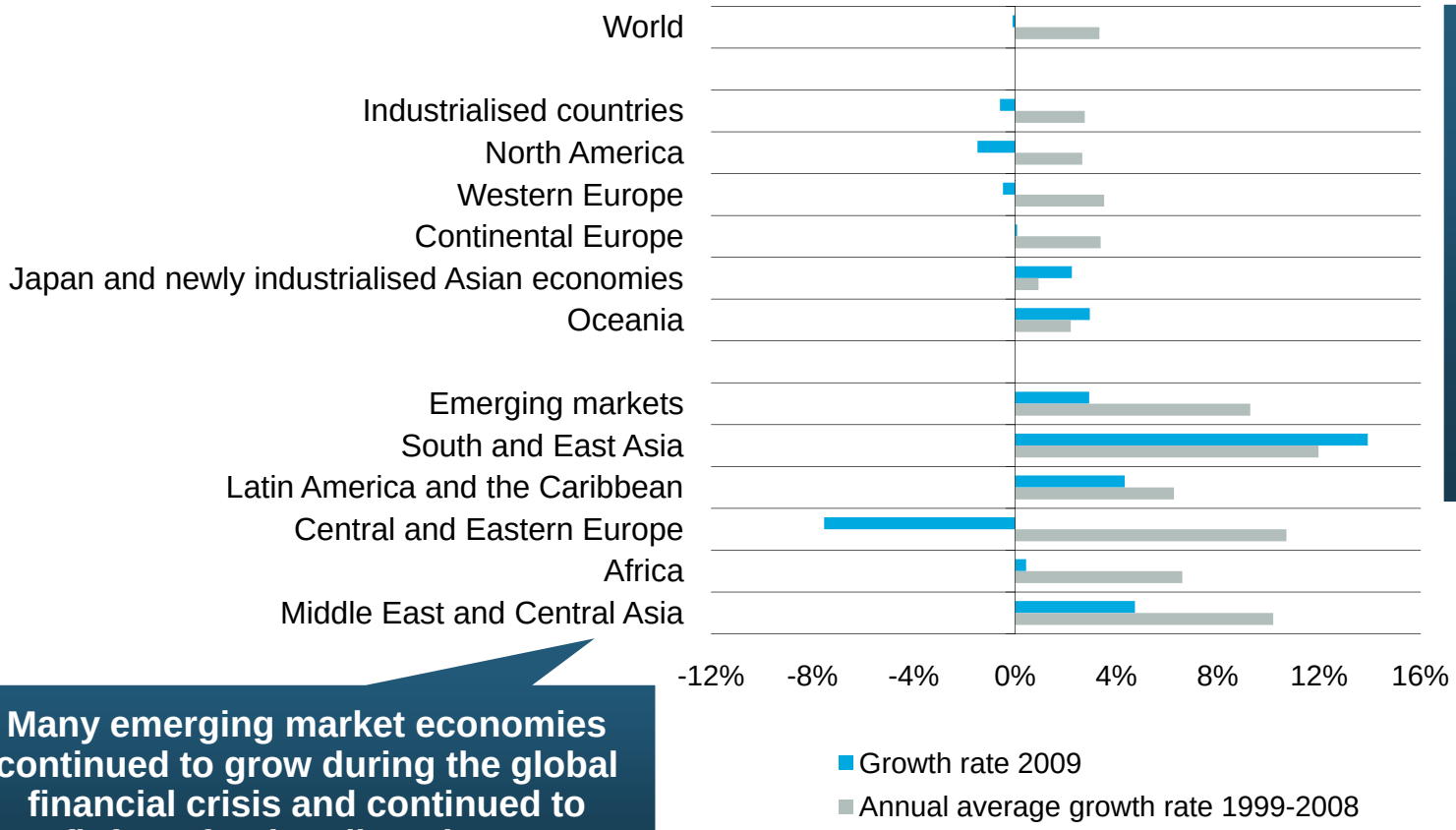
Real Premium Growth Rates



Every emerging market region except Central and Eastern Europe experienced growth during the financial crisis

Many emerging market economies continued to grow during the global financial crisis and continued to benefit from foreign direct investment

Source: Swiss Re, *sigma*, No. 2/2010.

Distribution of Nonlife Premium: Industrialized vs. Emerging Markets, 2009

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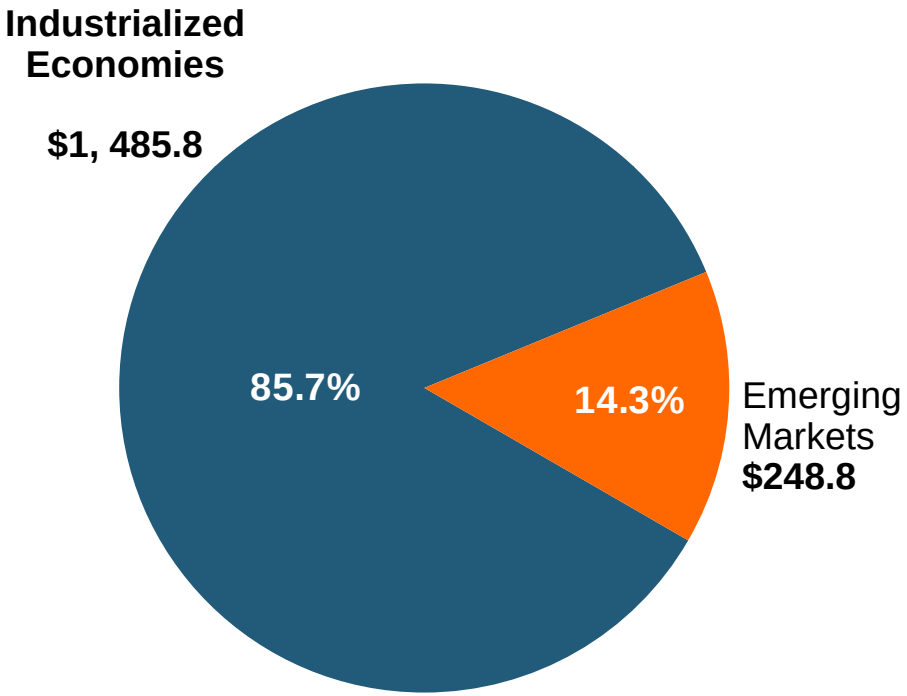
Premium Growth Facts

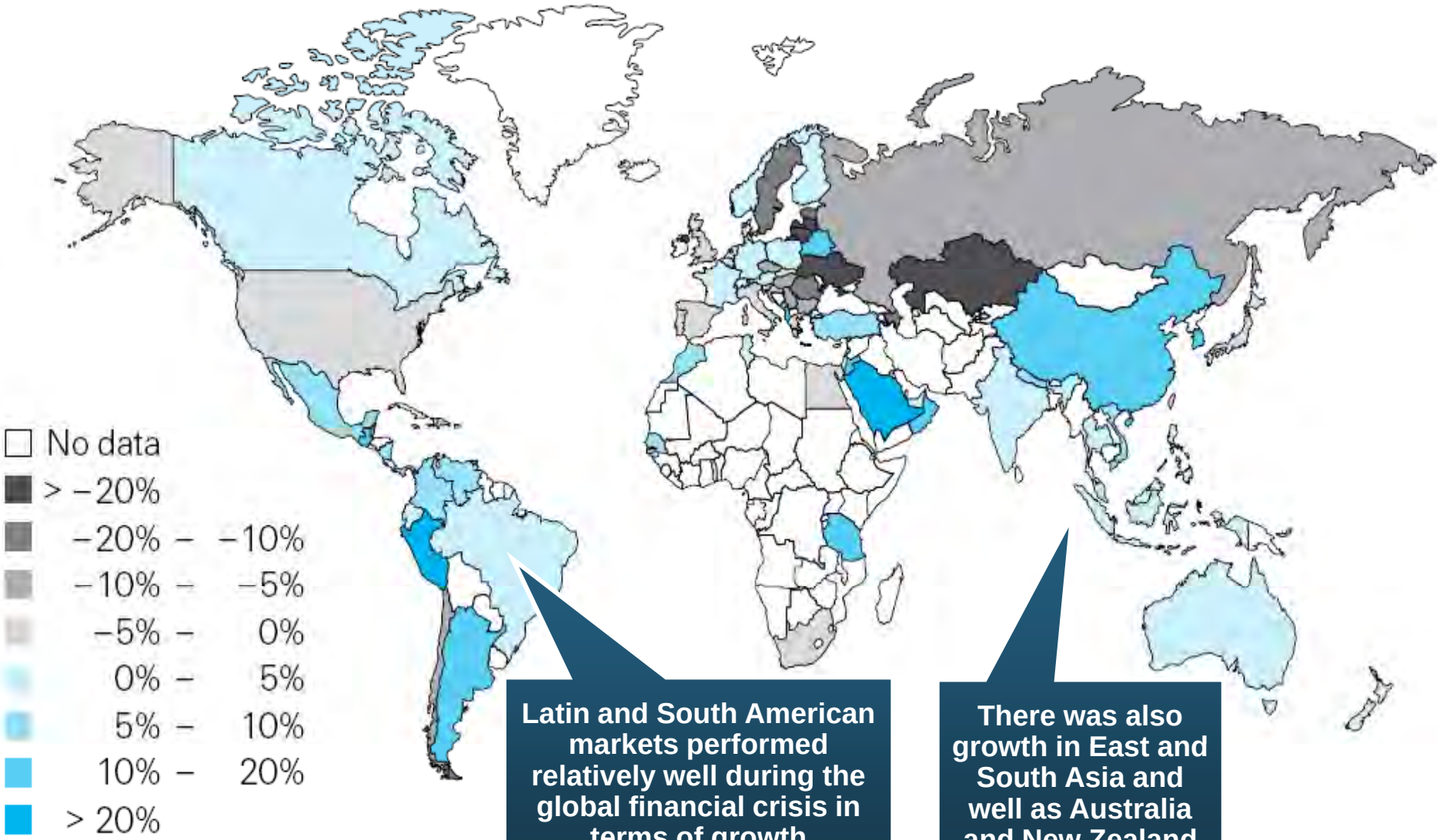
- Although premium growth throughout the industrialized world was negative in 2009, its share of global nonlife premiums remained very high at nearly 86%--accounting for nearly $1.5 trillion in premiums.
- The financial crisis and sluggish recovery in the major insurance markets will accelerate the expansion of the emerging market sector

2009, $Billions



Sources: NAIC; Insurance Information Institute research.

Nonlife Real Premium Growth in 2009



Latin and South American markets performed relatively well during the global financial crisis in terms of growth

There was also growth in East and South Asia and well as Australia and New Zealand

Source: Swiss Re, *sigma*, No. 2/2010.

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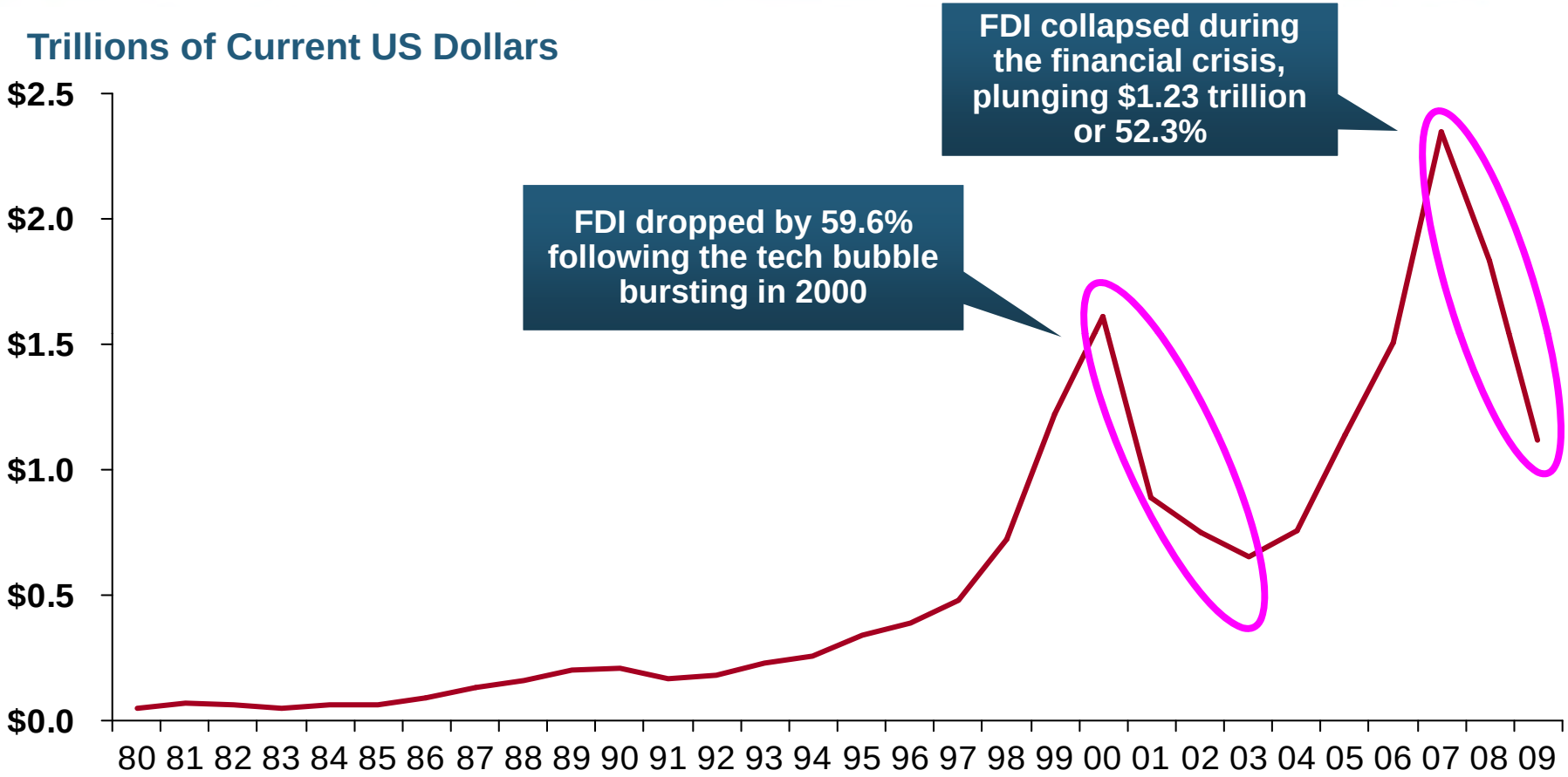
Reshuffling the Global Economic Deck Through *Foreign Direct Investment*

The Global Financial Crisis Crystallized Insurers' Long-Run Path to Growth

Global Foreign Direct Investment, Net Inflows: 1980-2009*



Most Non-Life Insurer Growth Will Be in Parts of the World Where Foreign Direct Investment is High. FDI Flows Are Highly Volatile Meaning that New Income Streams for Insurers Will Also Be Volatile

*Foreign Direct Investments are defined as the net inflows of investment to acquire a lasting management interest (at least 10% of voting stock) in an enterprise operating in an economy other than that of the investor.

Source: World Bank; Insurance Information Institute.

Following the Money Trail: Foreign Direct Investment

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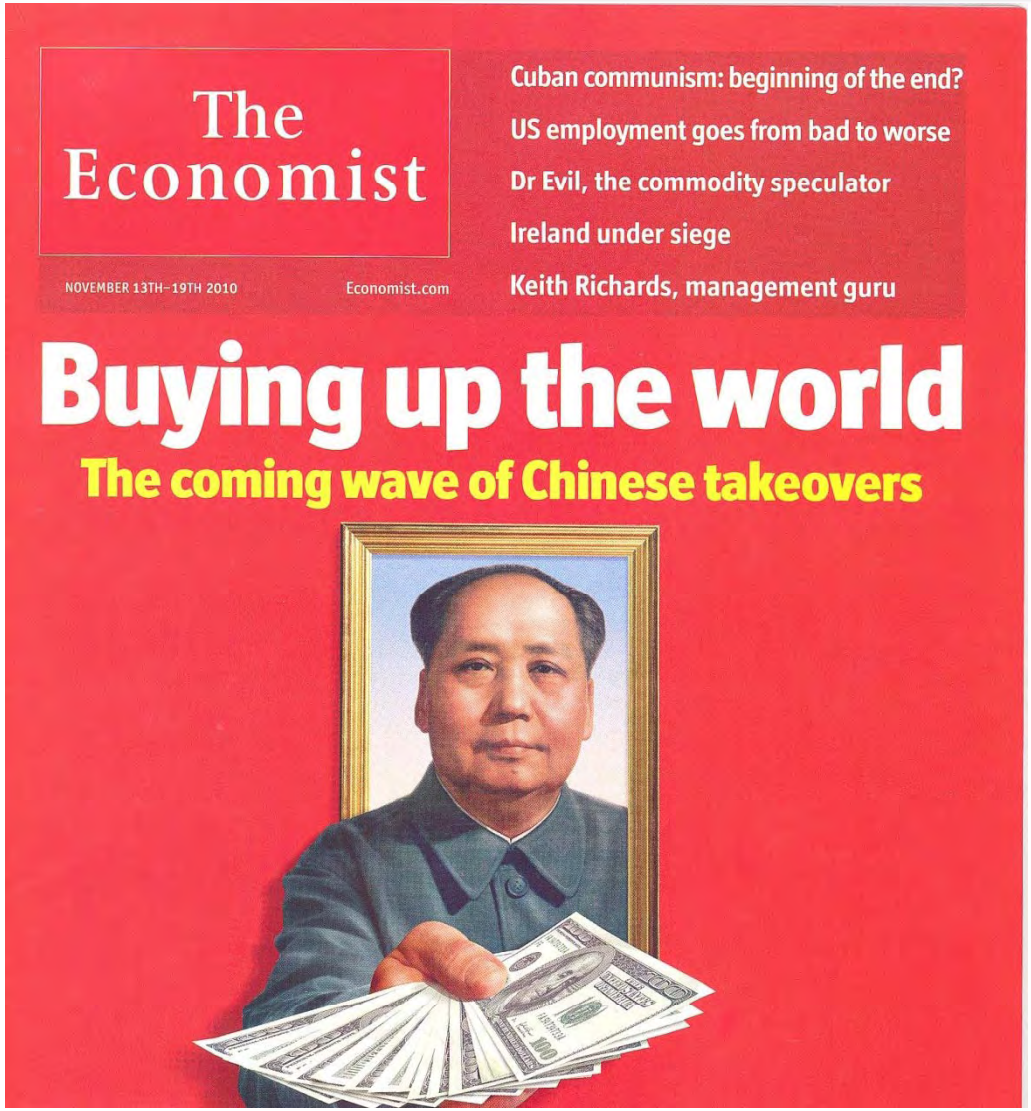

Source: *The Economist*, Nov. 13 -19, 2010

Following the Money Trail: Foreign Direct Investment

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The UK's share of FDI peaked at 45% in 1914

The US's share of FDI peaked at 50% in 1967

China's share of FDI stood at 6% in 2009

Source: *The Economist*, Nov. 13 -19, 2010

Crisis Driven Change in Outward Foreign Direct Investment by Region: Who's Creating Global Insurance Exposure?

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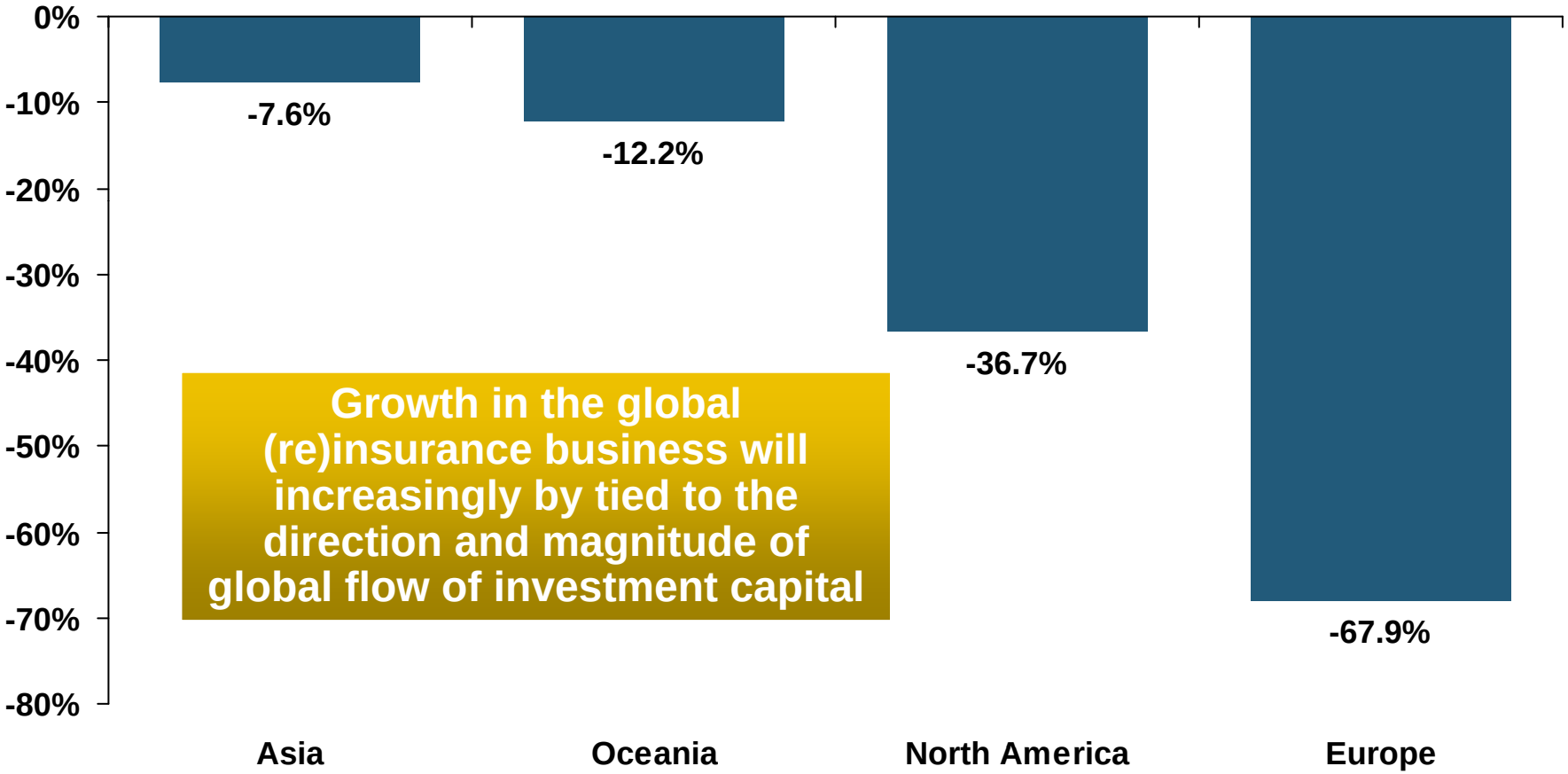
(Percent)

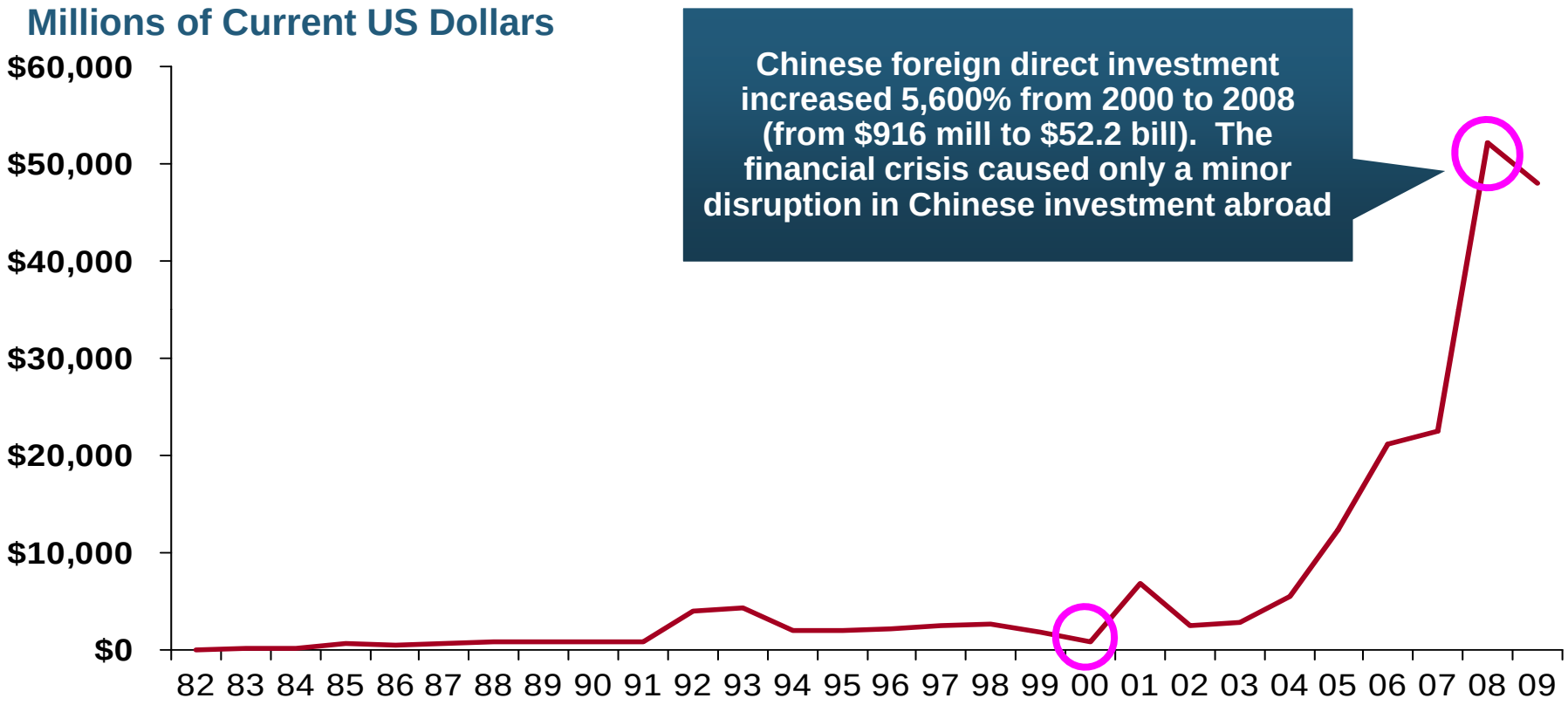


Growth in the global (re)insurance business will increasingly by tied to the direction and magnitude of global flow of investment capital

*Foreign Direct Investments are defined as the net inflows of investment to acquire a lasting management interest (at least 10% of voting stock) in an enterprise operating in an economy other than that of the investor. Outward FDI represents flow from investing country to rest of the world.

Source: United Nations UNCTADSTAT; Insurance Information Institute.

China: *Outward* Foreign Direct Investment: 1982-2009*



Despite the Crash in Foreign Direct Investment During the Global Financial Crisis, Chinese Investments Abroad Remain Near Record Levels. Implication: Growth Opportunities for Insurers May *Not* Be in China but In Chinese Investment Target Nations/Companies/Industries.

*Foreign Direct Investments are defined as the net inflows of investment to acquire a lasting management interest (at least 10% of voting stock) in an enterprise operating in an economy other than that of the investor. Outward FDI represents flow from investing country to rest of the world.

Source: United Nations UNCTADSTAT; Insurance Information Institute.

Major Chinese Banks' Loans Abroad: 2006-2009

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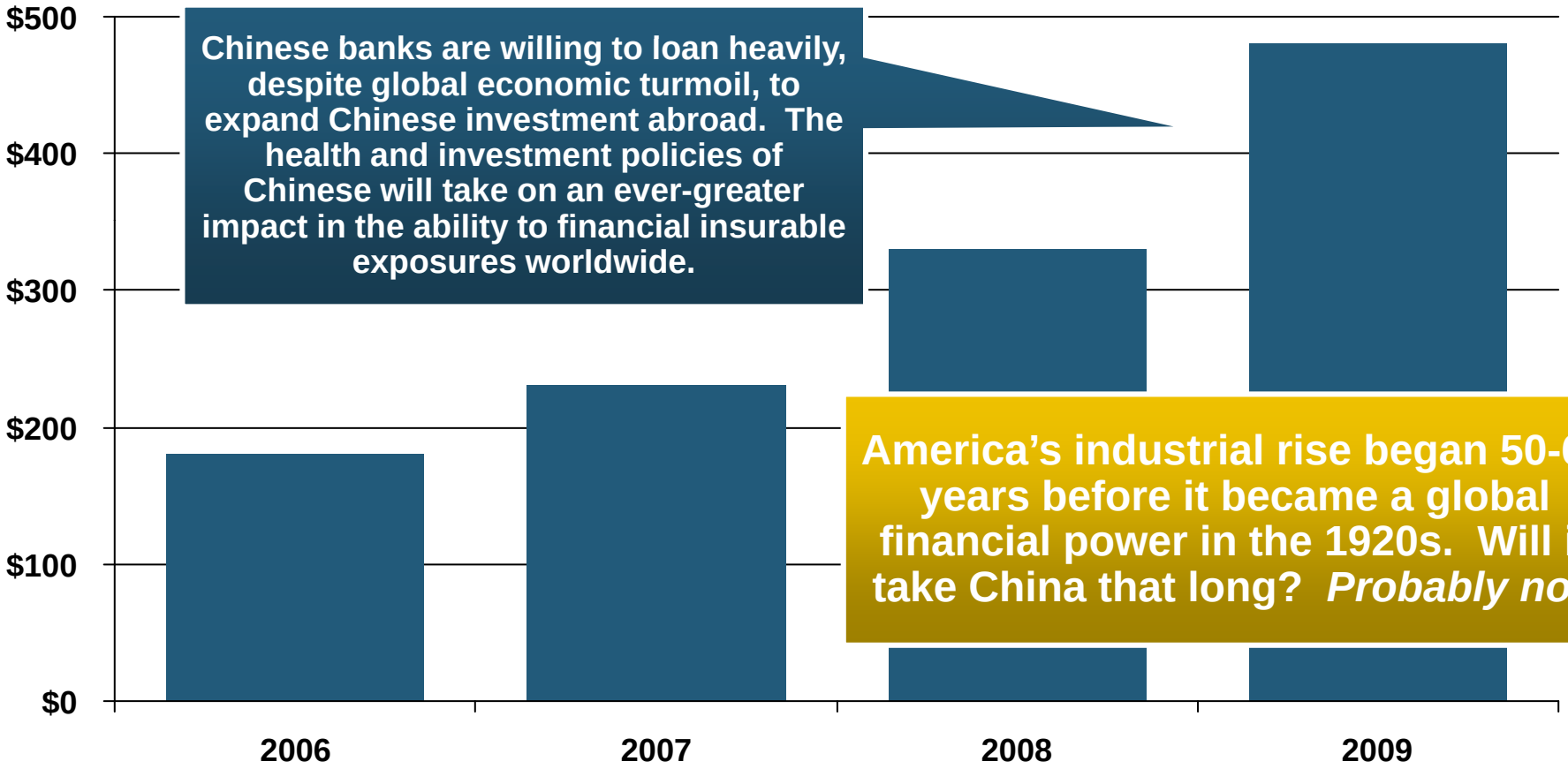
(Billions of US $)



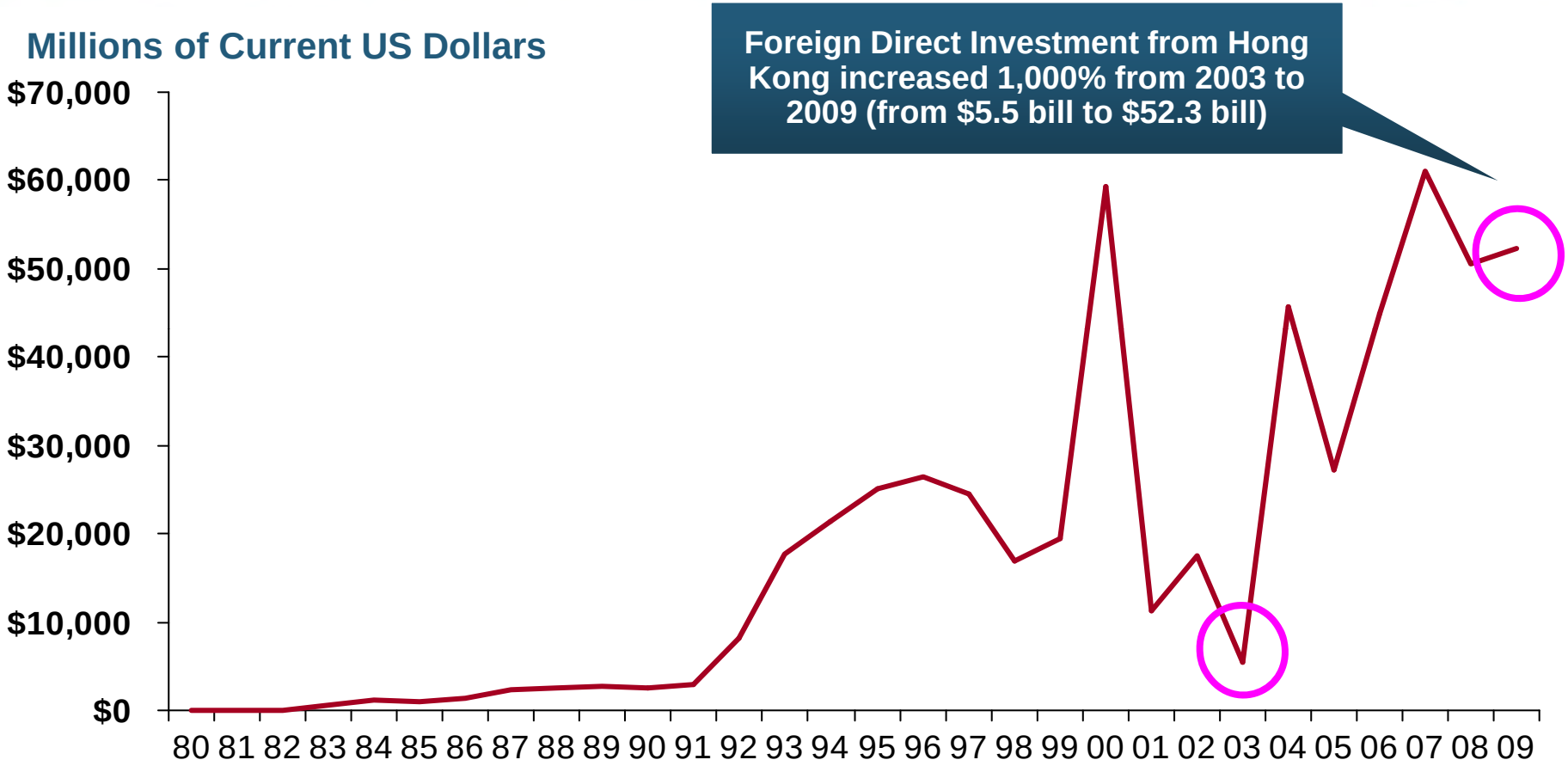
Chinese banks are willing to loan heavily, despite global economic turmoil, to expand Chinese investment abroad. The health and investment policies of Chinese will take on an ever-greater impact in the ability to financial insurable exposures worldwide.

America's industrial rise began 50-60 years before it became a global financial power in the 1920s. Will it take China that long? *Probably not.*

Chinese Banks' Lending Activity Abroad Showed Little Impact from the Global Financial Crisis

Source: Data estimated from The Economist, Nov. 13-19, 2010 from: ICBC, China Construction Bank, China Development Bank, Bank of China and China Eximbank.

Hong Kong: *Outward* Foreign Direct Investment: 1980-2009*

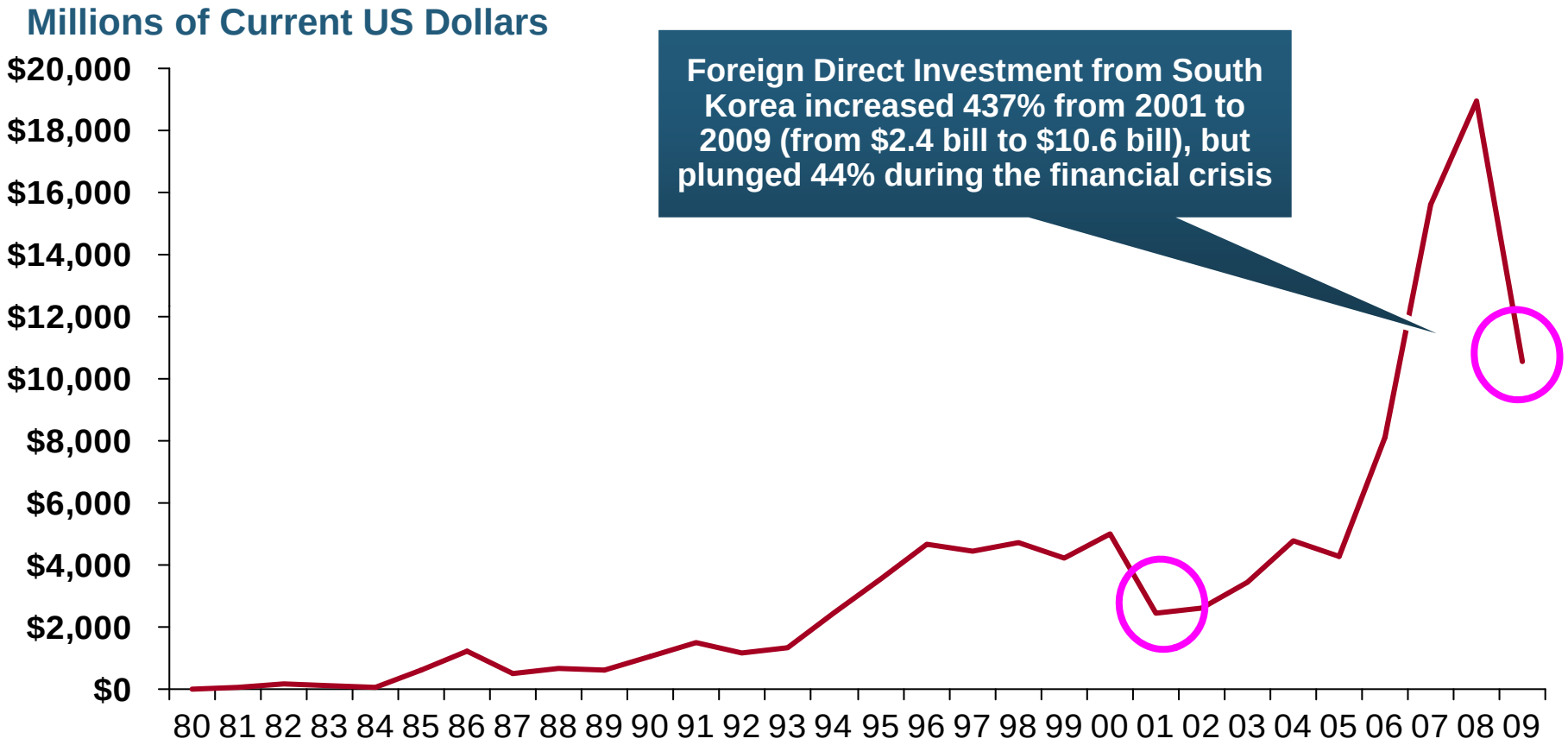


Despite the Crash in Foreign Direct Investment During the Global Financial Crisis, Investments Abroad by Hong Kong Remain Near Record Levels

*Foreign Direct Investments are defined as the net inflows of investment to acquire a lasting management interest (at least 10% of voting stock) in an enterprise operating in an economy other than that of the investor. Outward FDI represents flow from investing country to rest of the world.

Source: United Nations UNCTADSTAT; Insurance Information Institute.

South Korea: *Outward* Foreign Direct Investment: 1980-2009*

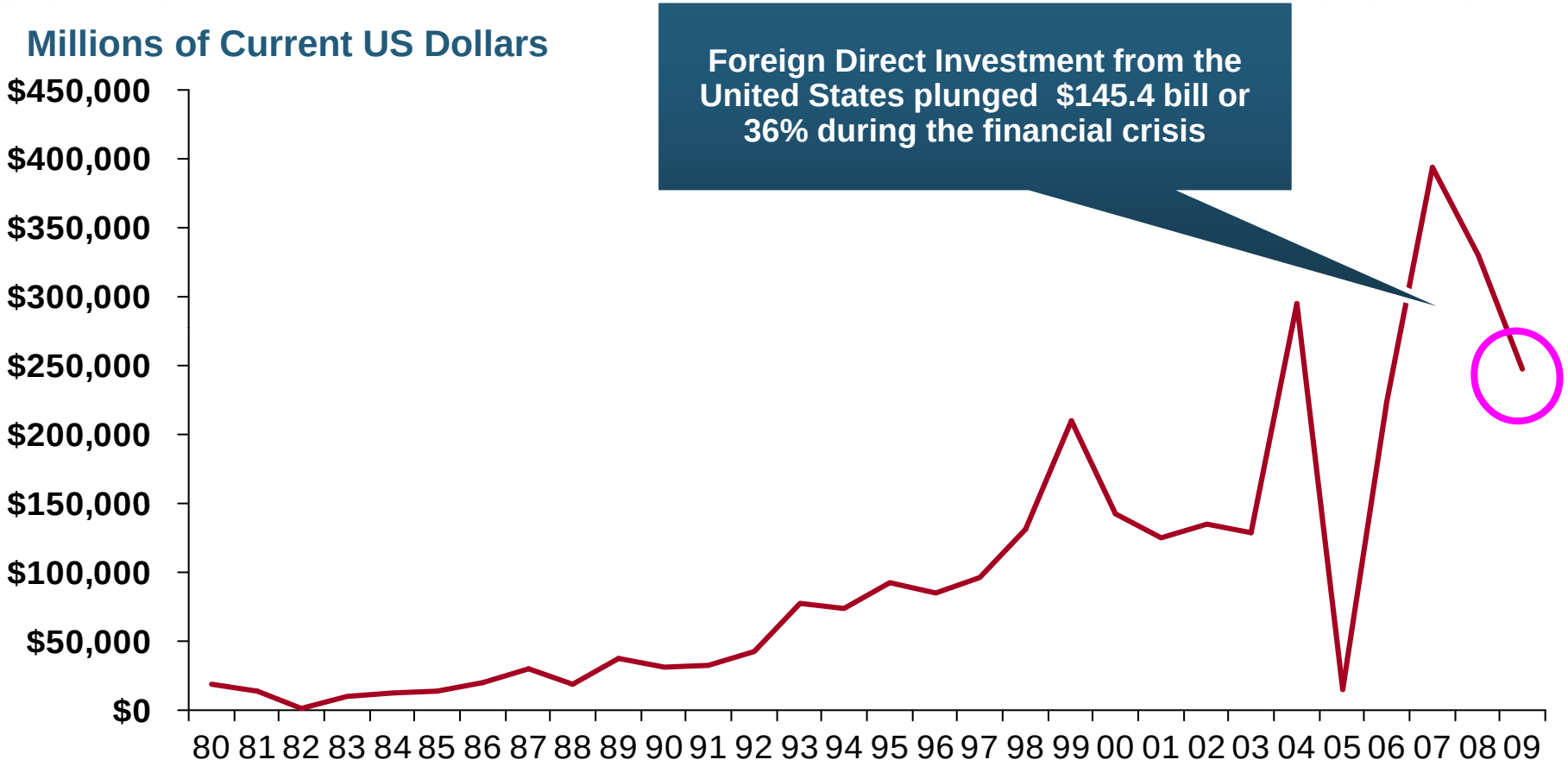


The Global Financial Crisis Hit South Korean Foreign Direct Investment Abroad Harder than Was the Case in Several of Its Neighbors

*Foreign Direct Investments are defined as the net inflows of investment to acquire a lasting management interest (at least 10% of voting stock) in an enterprise operating in an economy other than that of the investor. Outward FDI represents flow from investing country to rest of the world.

Source: United Nations UNCTADSTAT; Insurance Information Institute.

United States: *Outward* Foreign Direct Investment: 1980-2009*



Direct Investments Abroad by US Interests Were Hit Hard by the Global Financial Crisis

*Foreign Direct Investments are defined as the net inflows of investment to acquire a lasting management interest (at least 10% of voting stock) in an enterprise operating in an economy other than that of the investor. Outward FDI represents flow from investing country to rest of the world.

Source: United Nations UNCTADSTAT; Insurance Information Institute.

Europe: *Outward* Foreign Direct Investment: 1980-2009*

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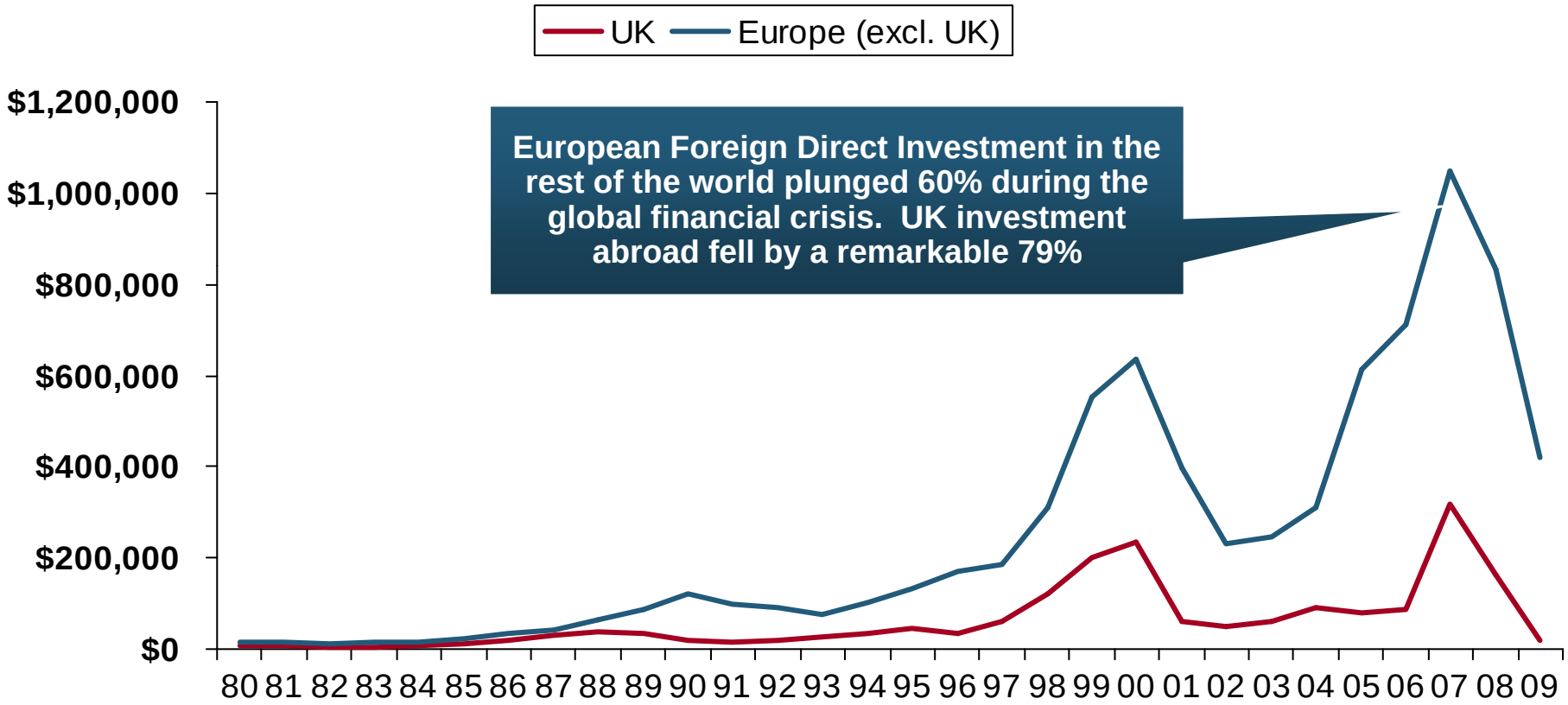
Millions of Current US Dollars



European Foreign Direct Investment Abroad Was Hit Much Harder than Asia or the Americas

*Foreign Direct Investments are defined as the net inflows of investment to acquire a lasting management interest (at least 10% of voting stock) in an enterprise operating in an economy other than that of the investor. Outward FDI represents flow from investing country to rest of the world.

Source: United Nations UNCTADSTAT; Insurance Information Institute.

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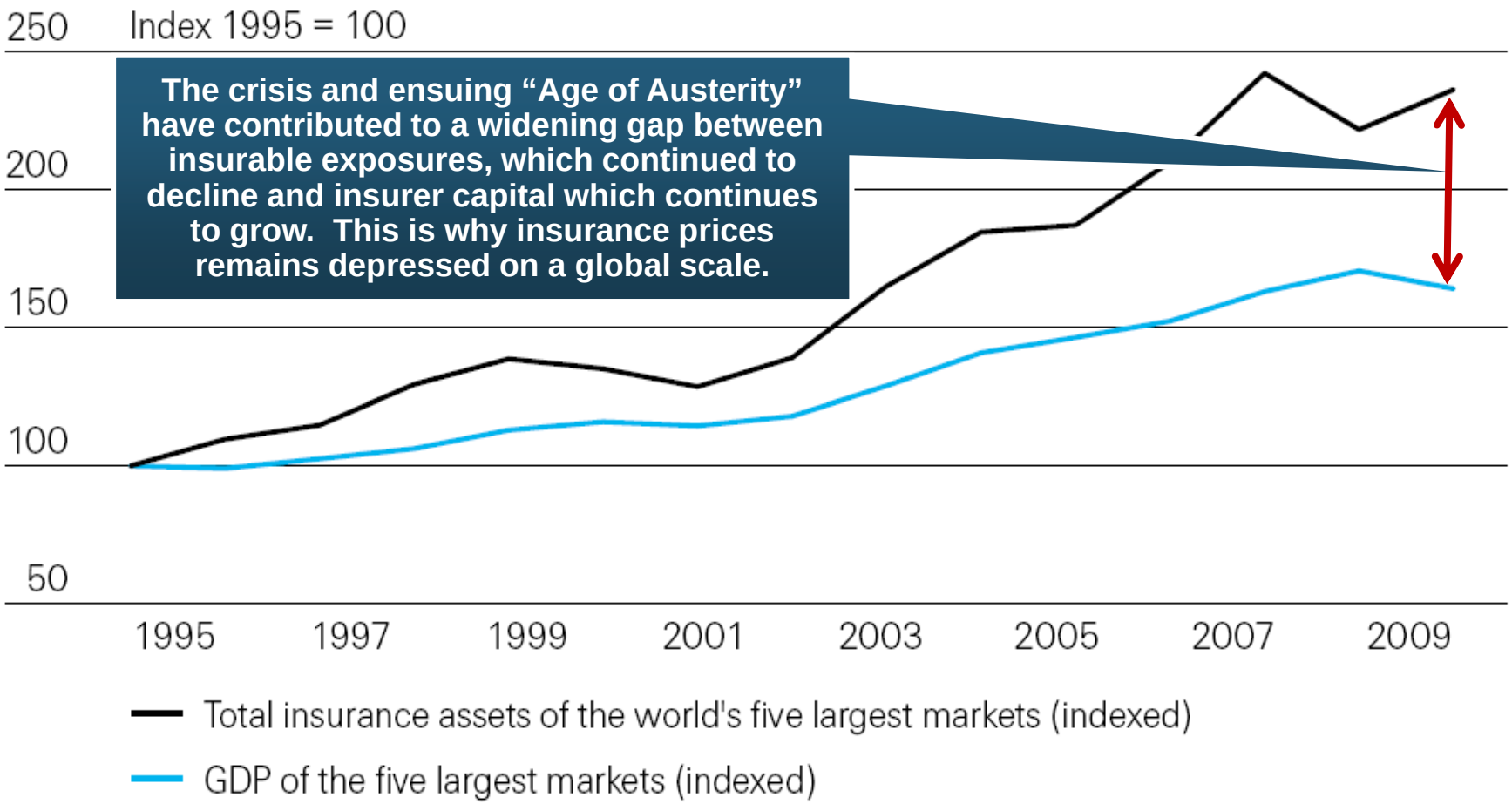
Insurance in the Age of Austerity

Governments in Most of the World's Major Insurance Markets Have Embraced Austerity

Significant Impacts for Global Insurance Demand

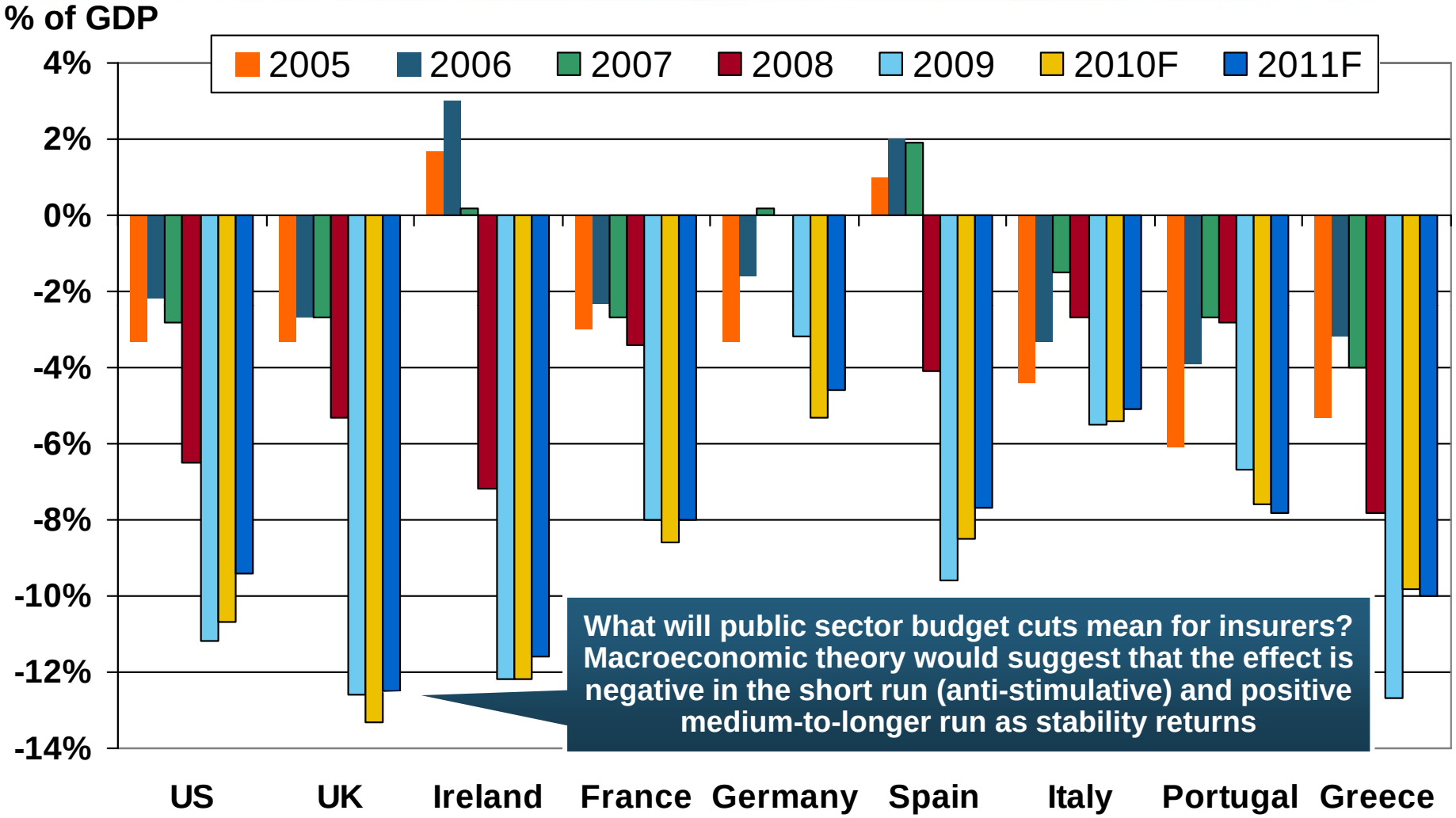
Growth of Nominal Insurance Assets and GDP, Five Largest Insurance Markets*



*The five largest insurance markets are the US, Japan, UK, France and Germany. Includes life and nonlife sectors.

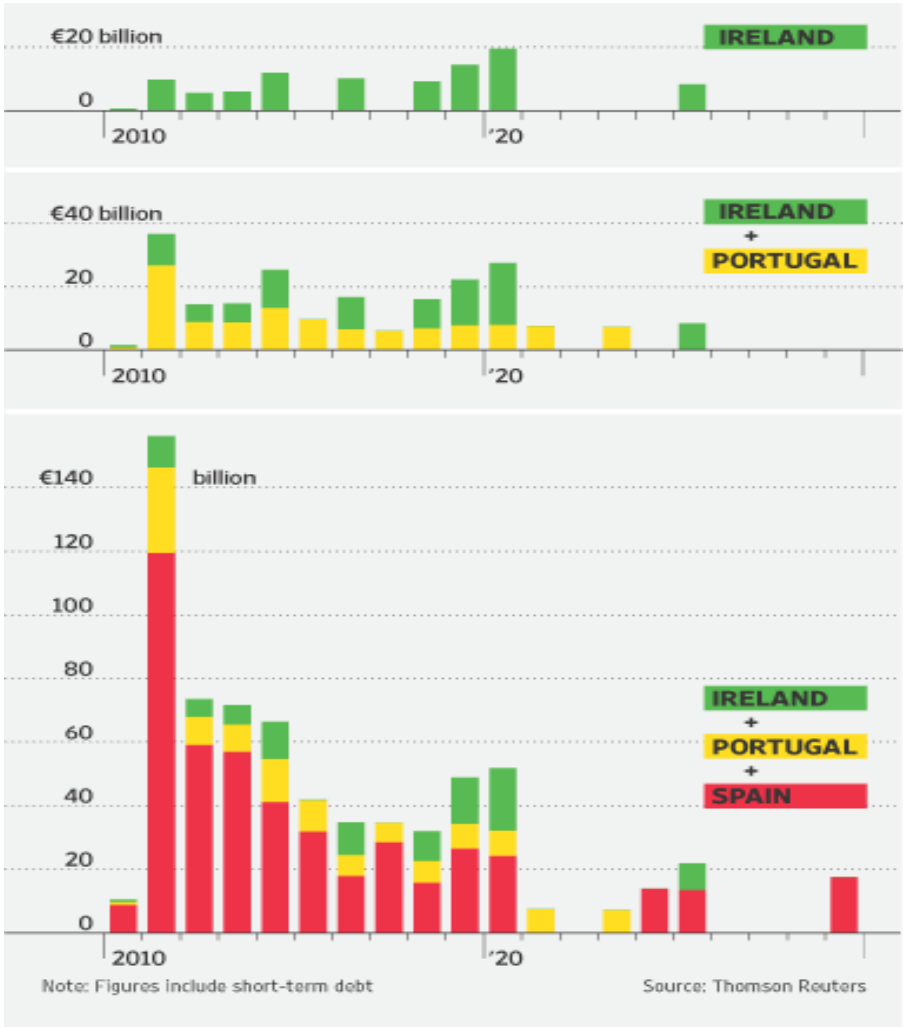
Source: Swiss Re, *sigma* no. 5, 2010.

Government Surplus/Deficit as a % of GDP, 2005-2011F



Source: Insurance Information Institute research.

Debt Issued by Three Euro-Zone Countries that Must Be Refinanced Over the Next 20 Years, by Due Date



Source: The Economist, 13-19 November, 2010 from Thomson Reuters; Insurance Information Institute

Credit Concerns

- Spain, Portugal and Ireland alone face nearly €150 billion in debt refinancing in 2011 and hundreds of billions in the years 2012-2030.
- Ireland's EU/IMF bailout package estimated at €150 billion; Greece at €110 billion
- Austerity measures are being implemented to manage this debt: includes budget cuts and tax increases
- While the return to sustainable fiscal policies will benefit the Euro Zone, the short term impact of austerity measures is likely to be negative for nonlife and life insurers

Planned/Proposed Actions to Trim Deficits as a Percent of GDP

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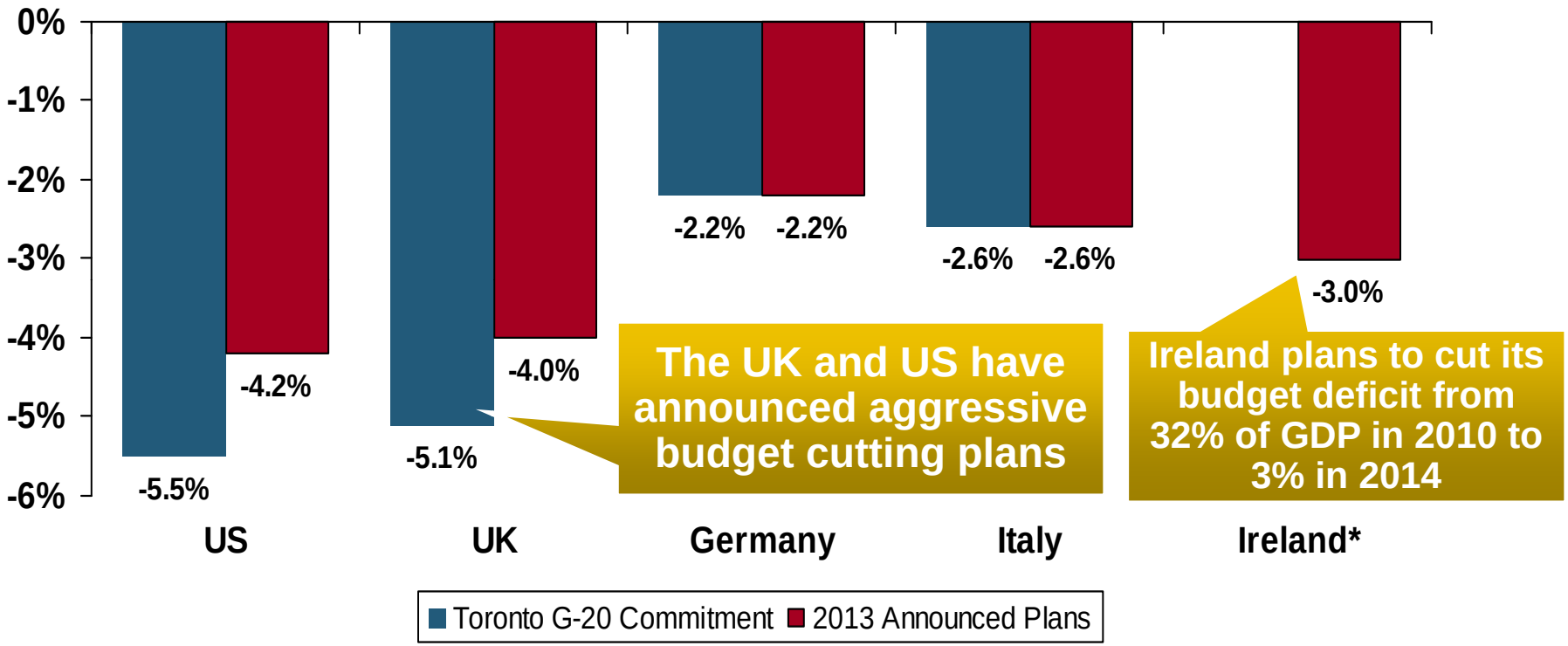
- Toronto Declaration (June 2010)
  - The G-20 countries agreed to reduce their "headline deficits" in half by 2013
  - But most countries plan to go beyond these targets
- EU "Excessive Deficit Procedure
  - Country-specific requirements to cut deficits to 3% of GDP per the Maastricht criteria*
    - By 2012 (Latvia, Lithuania, Italy)
    - By 2014 (Ireland, Greece, the UK)

* The Maastricht criteria are the criteria for member states to enter the third stage of European Economic and Monetary Union (EMU) and adopt the euro as their currency. The 4 main criteria are based on Article 121(1) of the European Community Treaty. The second criterion involves government finance. A country's ratio of the annual government deficit to gross domestic product (GDP) must not exceed 3% at the end of the preceding fiscal year. If not, it is at least required to reach a level close to 3%. Also, the ratio of gross government debt to GDP must not exceed 60% at the end of the preceding fiscal year.

Sources: International Monetary Fund, "Fiscal Exit: From Strategy to Implementation," *Fiscal Monitor*, November 2010, Ch. 3; http://en.wikipedia.org/wiki/Euro_convergence_criteria (Maastrict criteria)

Government Deficit as a % of GDP: Authorities' 2013 Plans*



The UK and US have announced aggressive budget cutting plans

Ireland plans to cut its budget deficit from 32% of GDP in 2010 to 3% in 2014

While the unwinding of the fiscal stimulus effects is likely to be negative in the short in the world's largest economies (which account for the majority of global premium volume), the longer-term effects should positive: increased financial market stability, positive economic growth and improved credit market conditions

*2014 for Ireland. 2010 deficit is 32% of GDP including bank bailouts, 11.7% excluding them.

Source: International Monetary Fund, "Fiscal Exit: From Strategy to Implementation," *Fiscal Monitor*, November 2010, Ch. 3, p. 41

Planned/Proposed Actions to Trim Deficits as a Percent of GDP

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- "Overall, in advanced countries, expenditure is expected to remain constant in real terms in 2010-2012
  - This reflects the "unwinding" of fiscal stimulus measures
  - Largest unresolved spending problem: health care costs
- Many countries are also hiking revenues
  - Personal income tax, corporate income tax, social security contributions, VATs, excise taxes
    - But some or all of these could dampen growth
    - IMF: fiscal consolidation of 1% of GDP tends to reduce GDP growth by 0.5% within two years

Sources: International Monetary Fund, "Fiscal Exit: From Strategy to Implementation," *Fiscal Monitor*, November 2010, Ch. 3; Neil Shah and Laurence Norman, "U.K. Economy Notches Growth," Wall Street Journal, Oct 27, 2010, p. A10.

Planned/Proposed Budget Cuts as a Percent of GDP

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- France
  - Freeze 2011 state spending
    - Goal: to bring the deficit to 3% of GDP by 2013.
    - Assumption: 2% GDP growth in 2011
    - Forecast for 2010 and 2011: Deficit cut from 7.7% of GDP in 2010 to 6% of GDP in 2011
    - Increase retirement age from 60 to 62
- UK
  - Planned cutbacks and tax increases of roughly 6% of GDP
  - Cut 500,000 public-sector jobs

Sources: Nathalie Boschat, "France to Freeze Spending," The Wall Street Journal Online, Sept 29, 2010; Neil Shah and Laurence Norman, "U.K. Economy Notches Growth," Wall Street Journal, Oct 27, 2010, p. A10.

Planned/Proposed Budget Cuts as a Percent of GDP

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- Greece
  - Goal: to bring the deficit to 7.5% of GDP by year-end 2011.
    - Assumptions: 4.2% contraction in GDP in 2010 and 3% drop in 2011
  - Current progress
    - Forecast 9.4% deficit in 2010, down from 15.4% in 2009
      - But the goal for 2010 deficit is 8.1% of GDP
  - Main Strategy: Structural reforms
    - Privatize deficit-ridden state-owned enterprises
    - Health care
    - Greece's dysfunctional tax-collection system

Sources: Aikman Granitsas, "IMF: Greece Needs More Reforms," The Wall Street Journal Online, Nov 23, 2010; Nick Skrekas, "Greece Sticks to Deficit Target in 2011 Budget," The Wall Street Journal Online, Nov 18, 2010.

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Economic Threats to the Global (Re)Insurance Industry

The World is Never Short on Threats to Insurer Growth and Performance

In The Aftermath of the Crisis, Major Global Economic Issues Remain

- Weak Economic Growth in World's Largest Insurance Markets
- Currency Market Instability
  - Depreciating Dollar
  - Rapid Appreciation of Developing Country Currencies
  - Concern Over Future of Euro
- Protectionism
- Bond Market Concerns (Greece, Spain, Ireland, etc.)
- Lingering European Bank Problems (Ireland)
- Austerity Measures
  - UK—radical reduction in budget, government employment
  - Greece, Ireland, France, Portugal, Spain
  - Need to get back in line with Euro Zone requirements
- Pension Reform
  - Strikes in France (over raising the retirement age from 60 to 62)
- Price Level Volatility
  - Deflation concerns (US, Japan)
  - Inflation (China, Brazil and other Newly industrial Countries)
- Regulatory Backlash/Developments
  - Solvency II, Basel III
  - US Financial Services Reform

Source: Insurance Information Institute.

Trade Index Weighted US Dollar Exchange Rate*

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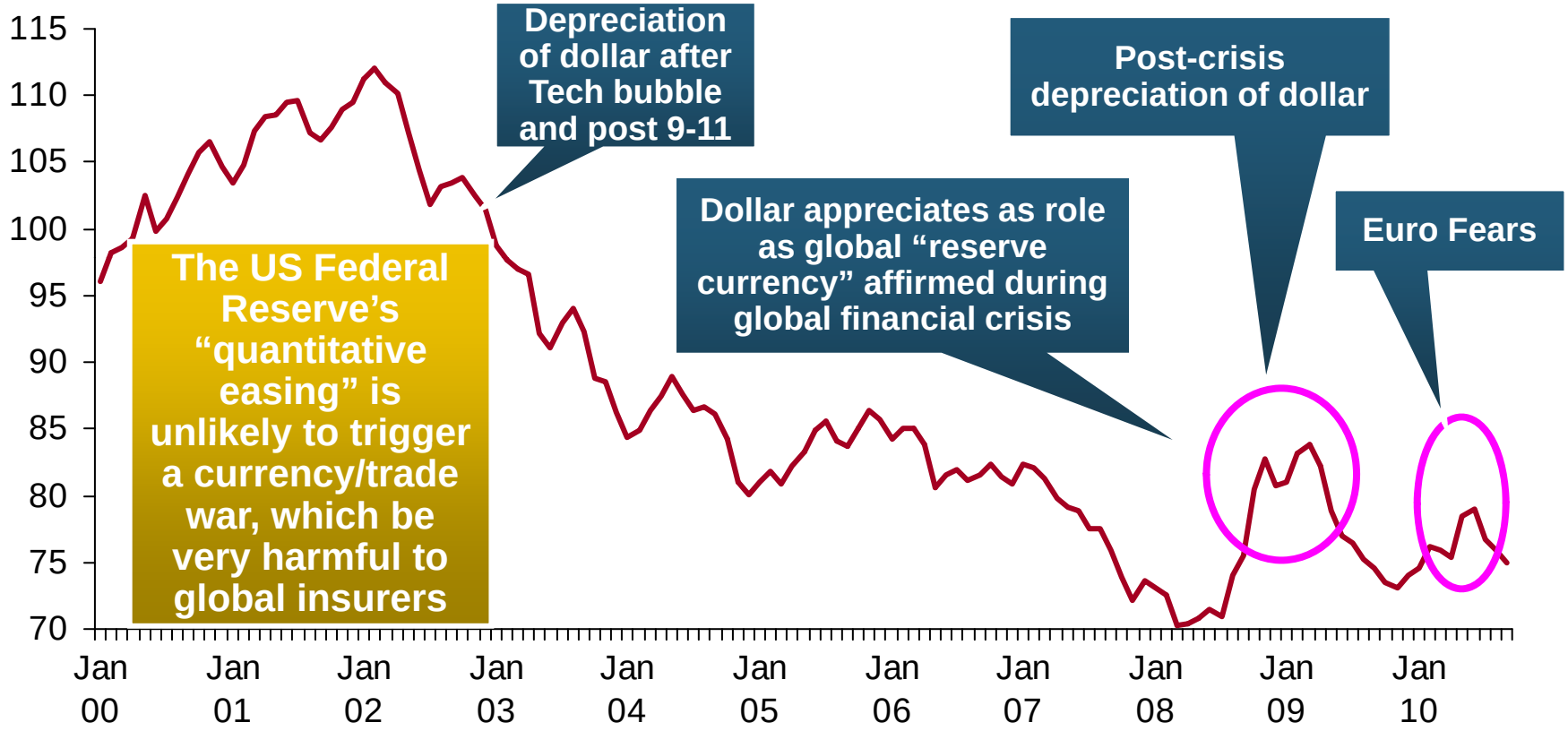
January 2000 through September 2010



The Global Financial Crisis Produced Significant Exchange Rate Volatility in 2008, 2009 and 2010; Role of Dollar a Safe Haven Affirmed During Crisis, but Dollar is Now Under Pressure Due to QE2

*The broad index is a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of major U.S. trading partners. The index weights, which change over time, are derived from U.S. export shares and from U.S. and foreign import shares.

Source: US Federal Reserve, Board of Governors; Insurance Information Institute.

Merchandise Exports Are Growing at Pre-Crisis Levels Again

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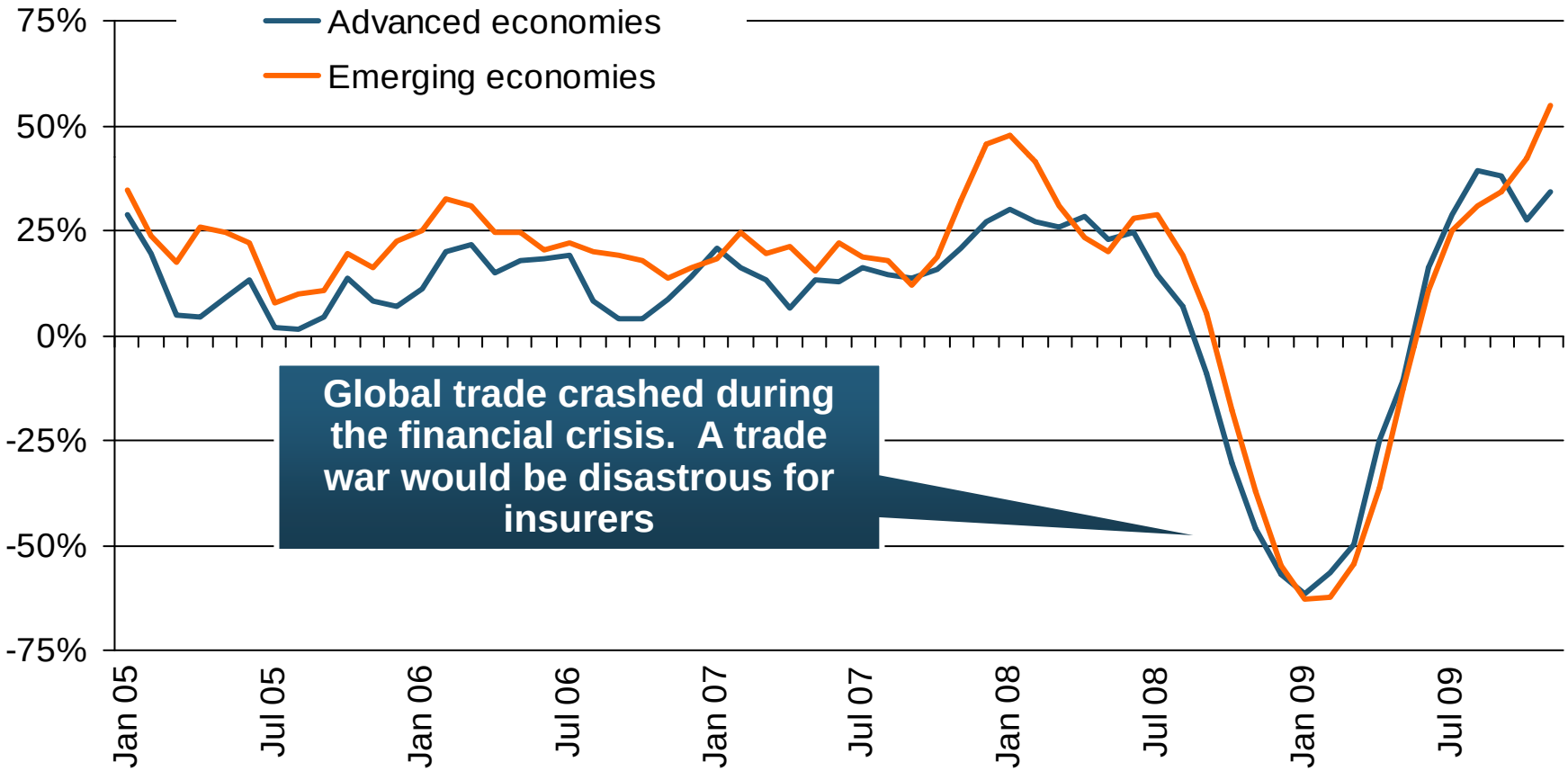
Annualized % change of 3-month moving average over previous 3-month moving average



Note: data are through November 2009
Source: International Monetary Fund World Economic Outlook January 2010 update at http://www.imf.org/external/pubs/ft/weo/2010/update/01/data/figure_2.csv

Inflation Rates for Largest European Economies & Euro Area, 2008-2011F

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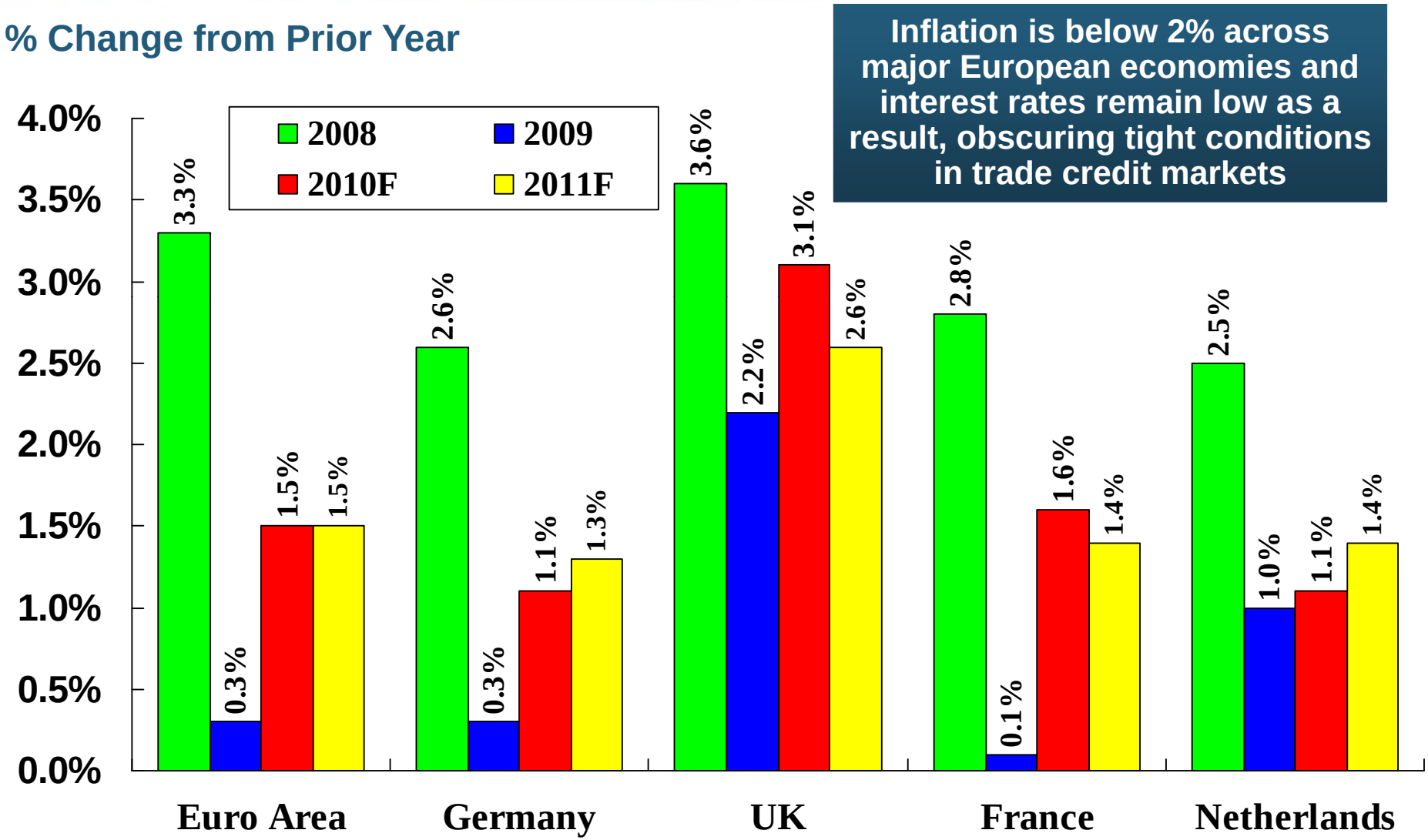
Inflation is below 2% across major European economies and interest rates remain low as a result, obscuring tight conditions in trade credit markets



Source: Blue Chip Economic Indicators, Oct. 2010 edition.

Inflation Rates for Other Important Countries, 2008-2011F

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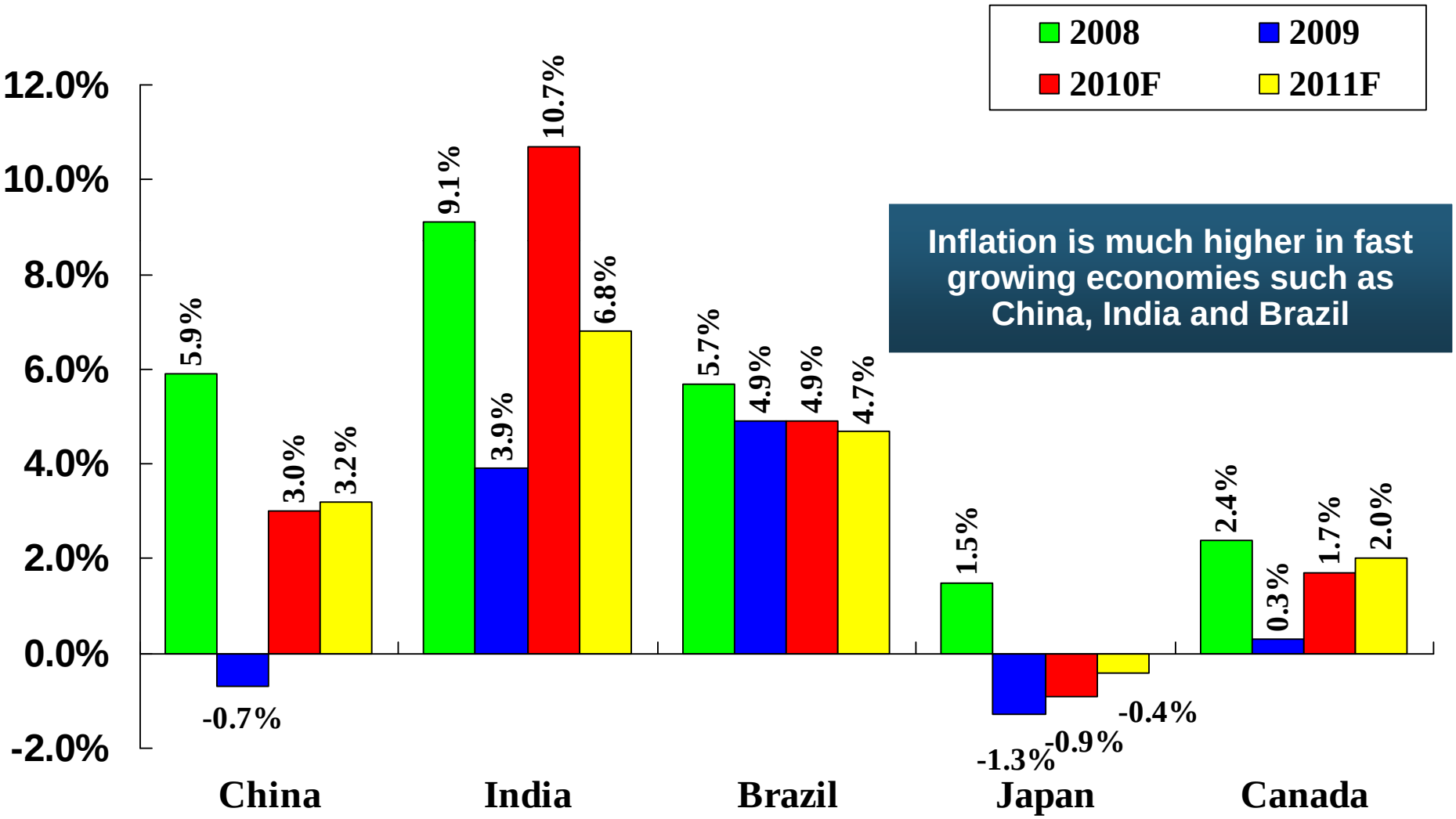
% Change from Prior Year



Inflation is much higher in fast growing economies such as China, India and Brazil

Source: Blue Chip Economic Indicators, Oct. 2010 edition.

3-Month Interest Rates for Major Global Economies, 2008-2011F

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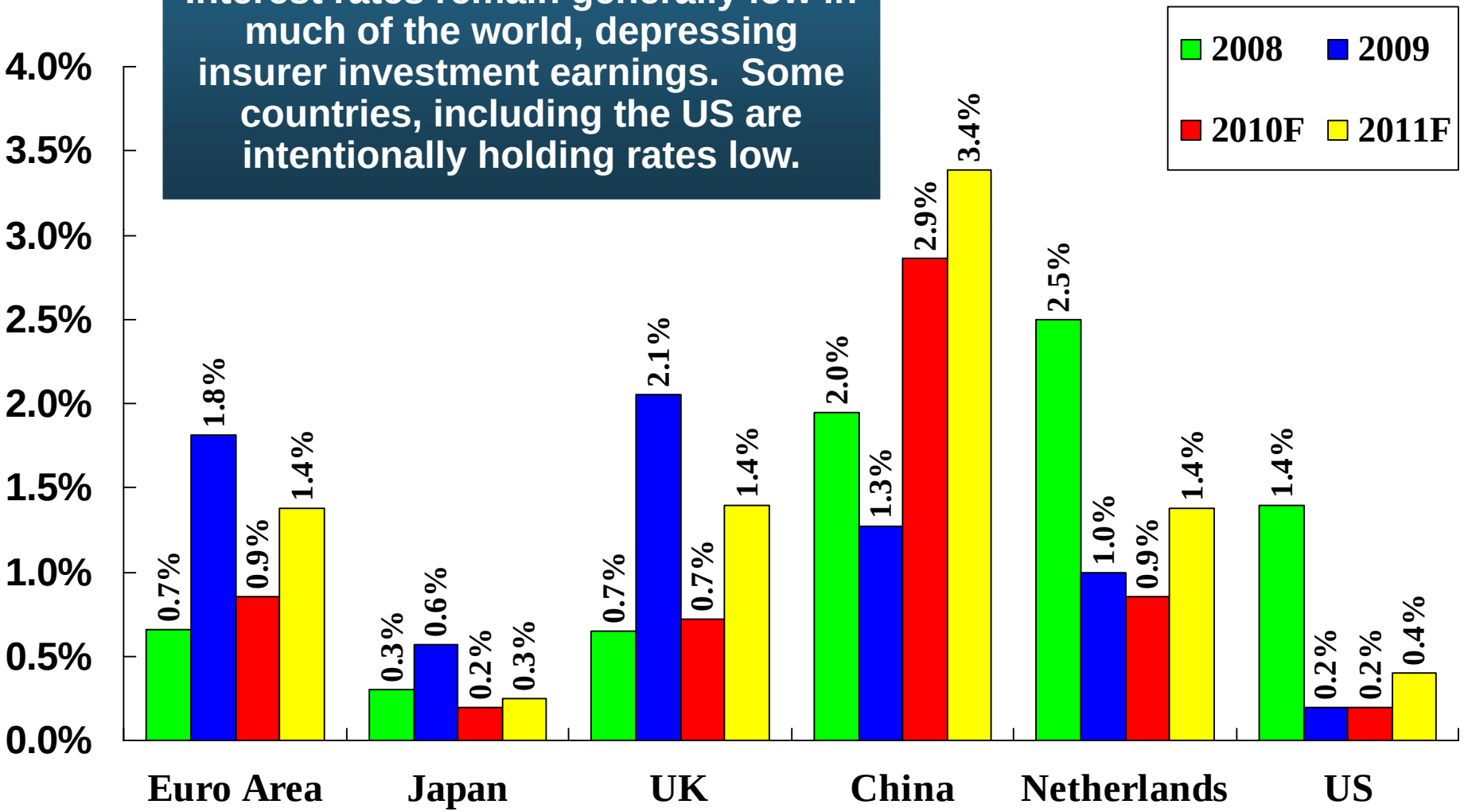
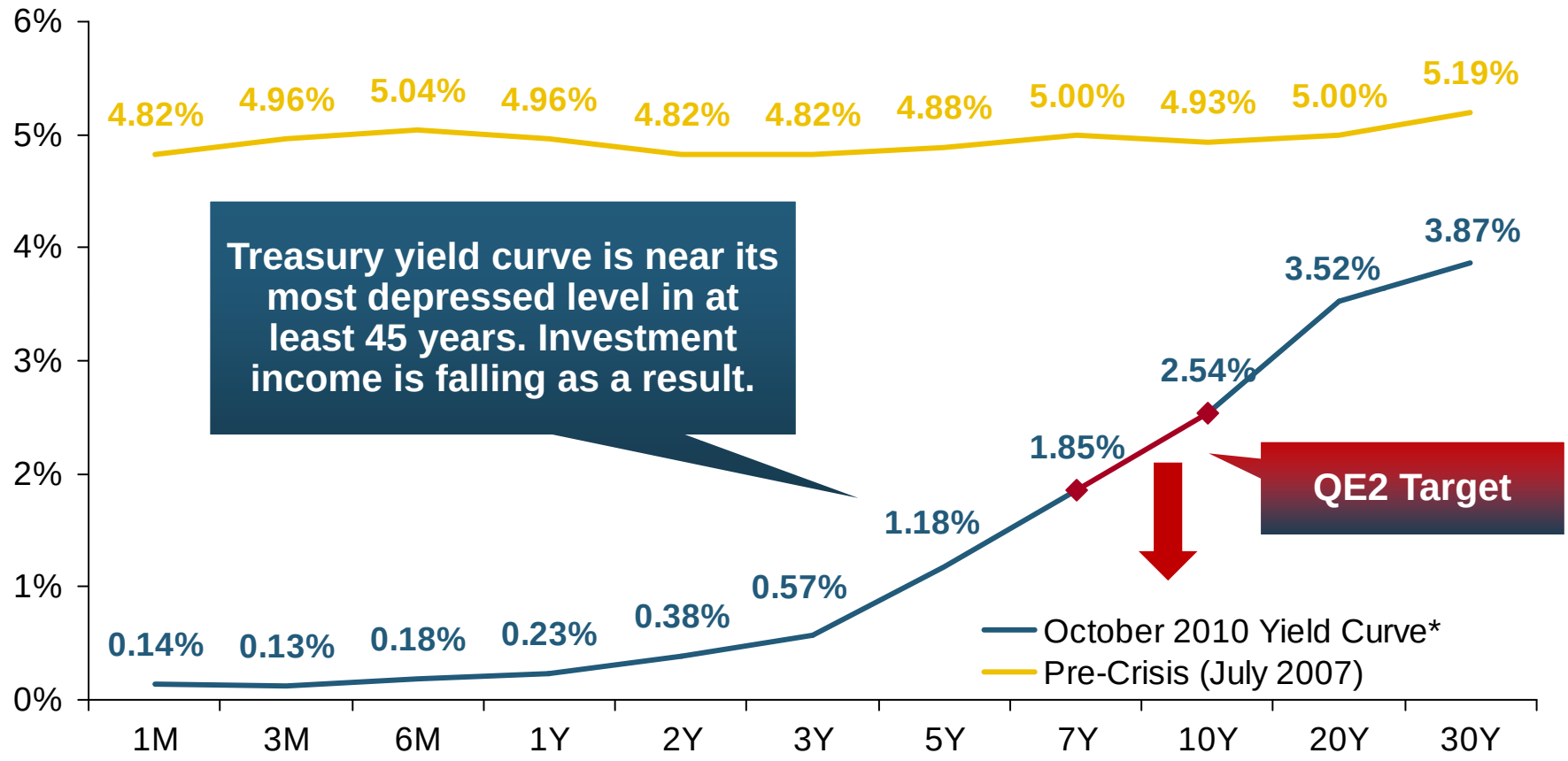
Interest rates remain generally low in much of the world, depressing insurer investment earnings. Some countries, including the US are intentionally holding rates low.



Source: Blue Chip Economic Indicators, Oct. 2010 edition.

US Treasury Yield Curves: Pre-Crisis (July 2007) vs. October 2010



The Fed's Announced Intention to Pursue Additional Quantitative Easing Could Further Depress Rates in the 7 to 10-Year Maturity Range

Sources: Board of Governors of the United States Federal Reserve Bank; Insurance Information Institute.

Internationally, Most Short-term Interest Rates Are Still Quite Low

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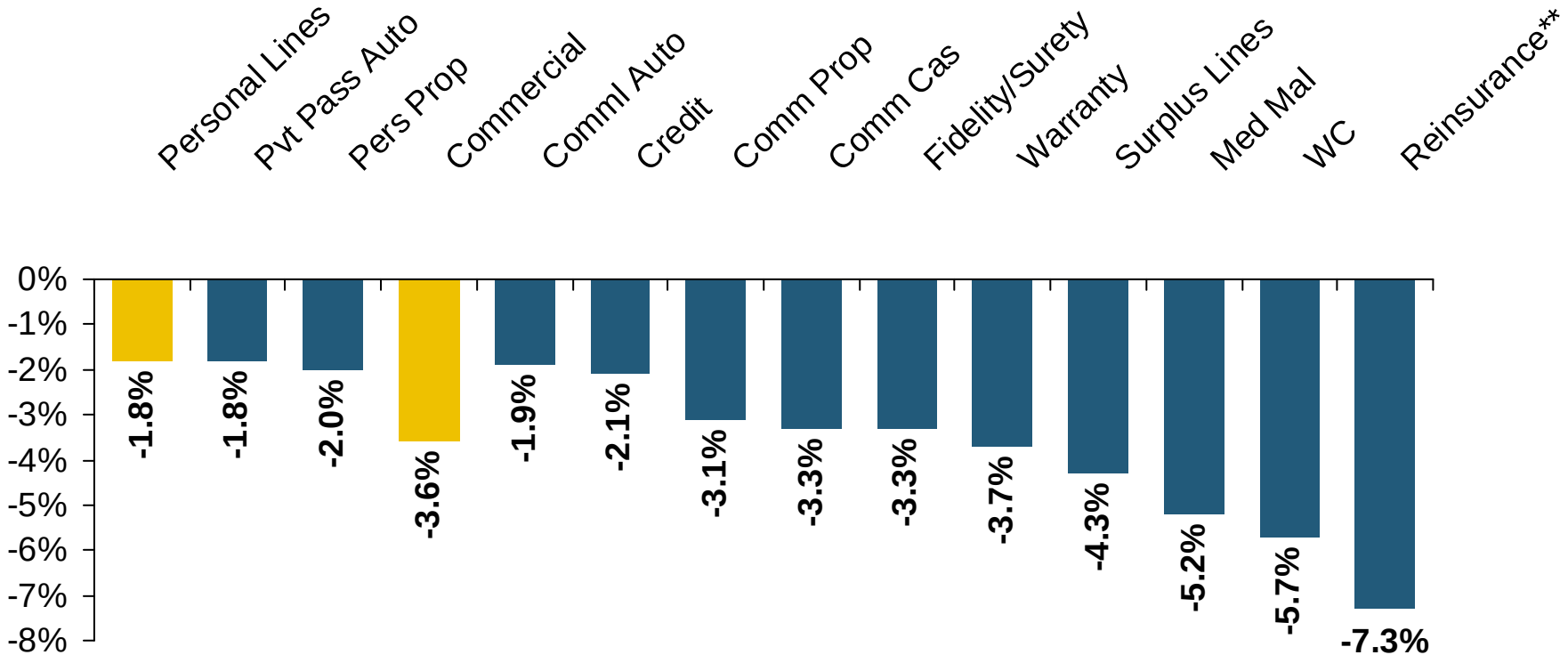
Central Bank	Current Interest Rate	Last Changed
Bank of Canada	0.25%	April 21, 2009
Bank of England	0.50%	March 5, 2009
Bank of Japan	0.10%	Dec 19, 2008
European Central Bank	1.00%	May 7, 2009
U.S. Federal Reserve	0.25%	Dec 16, 2008
The Reserve Bank of Australia	4.25%	April 6, 2010
China	5.31%	Dec 22,2008
Hong Kong SAR	0.50%	Dec 17, 2008
Korea, Republic of	2.00%	Feb 16, 2009
Hungary	5.50%*	Mar 29, 2010

*reduced from 5.75%
Source: http://www.fxstreet.com/fundamental/interest-rates-table/

US: Reduction in Combined Ratio Necessary to Offset 1% Decline in Investment Yield to Maintain Constant ROE, by Line*



Lower Investment Earnings Place a Greater Burden on Underwriting and Pricing Discipline

*Based on 2008 Invested Assets and Earned Premiums
**US domestic reinsurance only
Source: A.M. Best; Insurance Information Institute.

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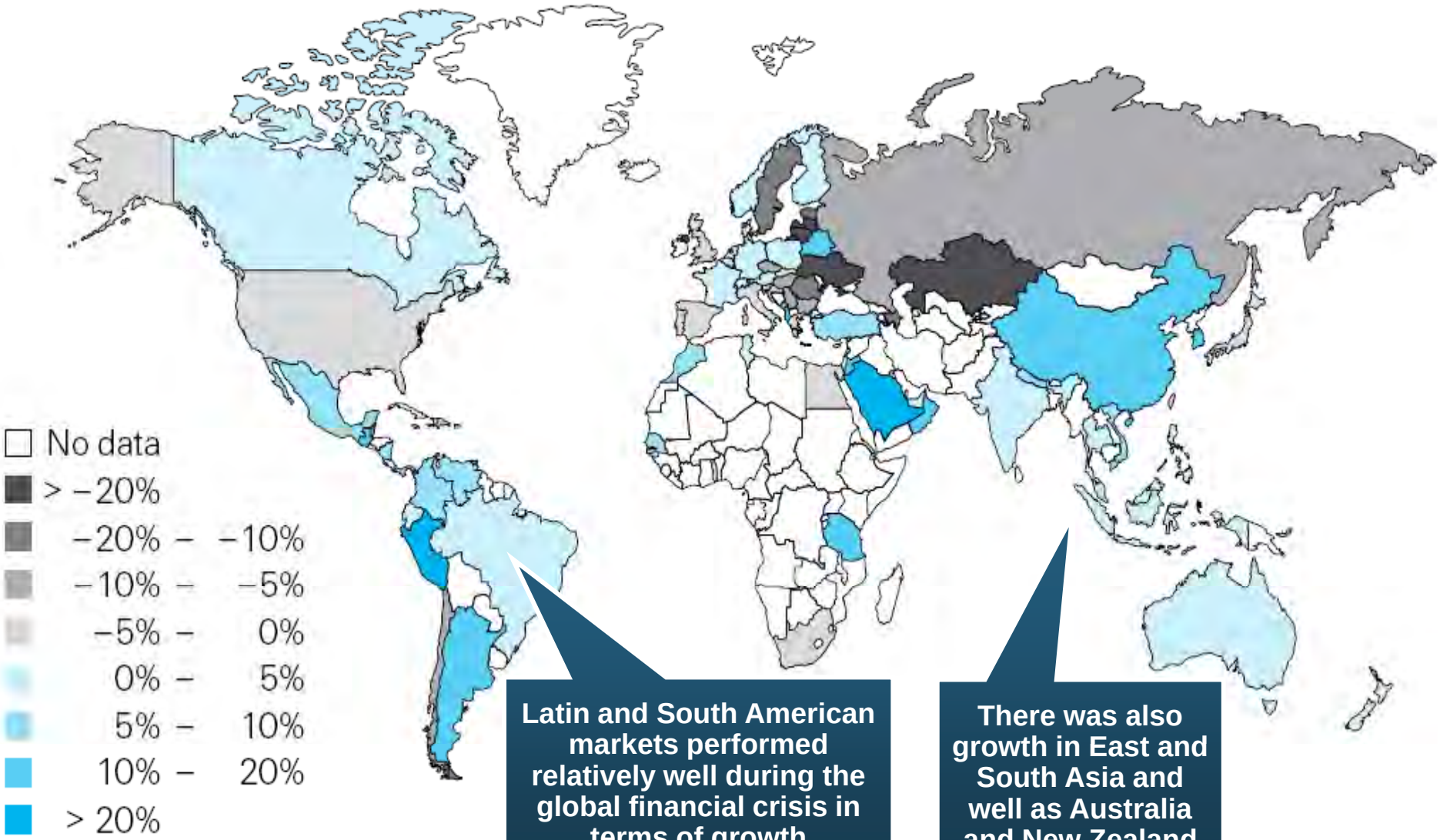
The Unfortunate Nexus: Opportunity, Risk & Instability

Most of the Global (Re)Insurance Industry's Future Gains Will be Fraught with Much Greater Risk and Uncertainty than in the Past

Nonlife Real Premium Growth in 2009



Latin and South American markets performed relatively well during the global financial crisis in terms of growth

There was also growth in East and South Asia and well as Australia and New Zealand

Source: Swiss Re, *sigma*, No. 2/2010.

Political Risk in 2010: Insurers Greatest Opportunities Are Often in Risky Nations

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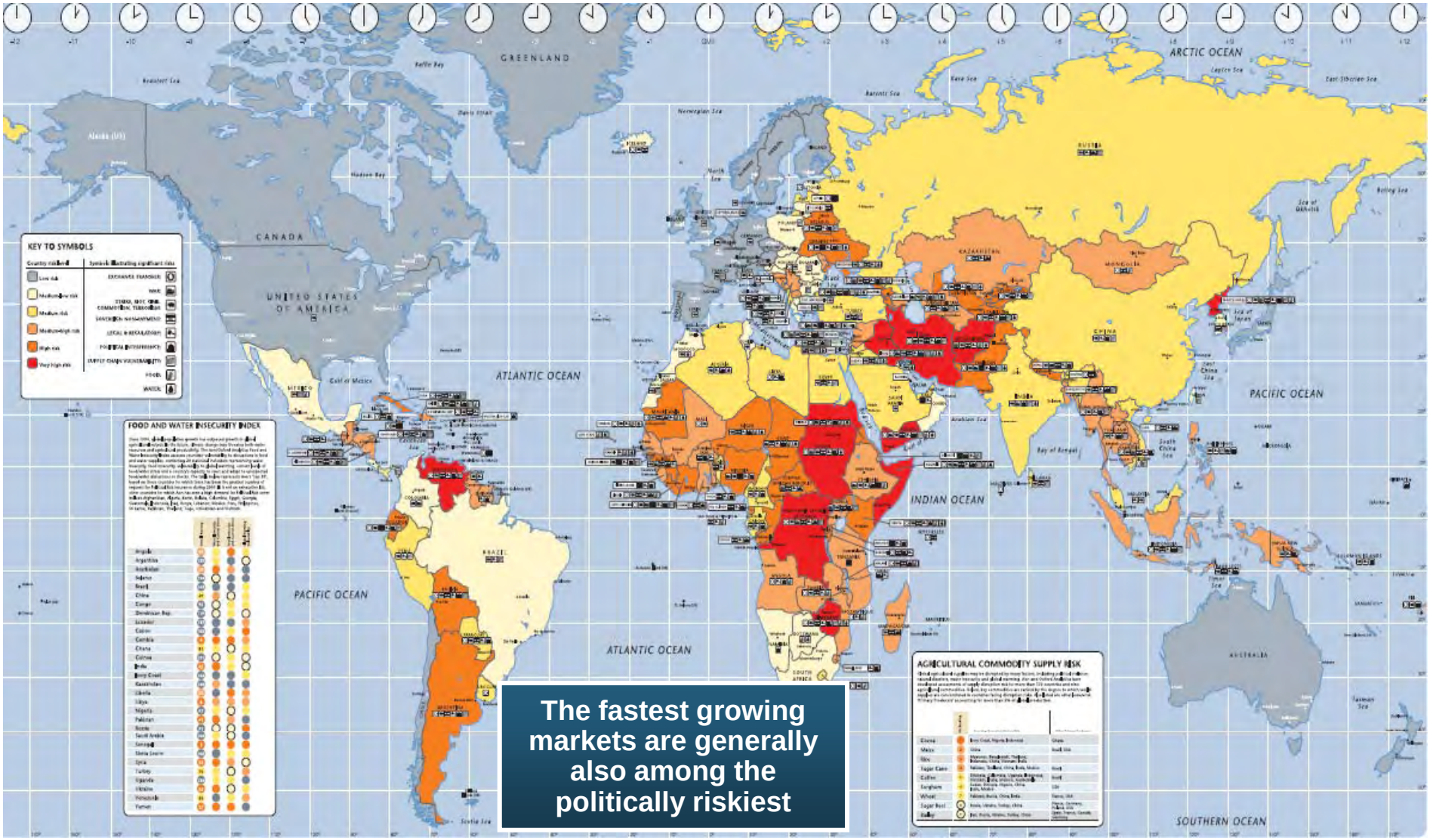

The fastest growing markets are generally also among the politically riskiest

Source: Aon

Aon 2010 Political Risk Map: Findings

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- **Elevated Political Risk Levels to Continue in 2010**
  - Significant volume of credit and political risk claims in international insurance markets have driven many of the ***18 country downgrades*** in this year's map.
  - Aon believes 2010 will see elevated political risk levels continue before an overall tendency for improving global business conditions becomes established. For many companies and across different sectors, including credit and political risk insurance, the business environment remains uncertain when trading with or investing in politically or economically unstable countries.
- **Movements on the 2010 Map**
  - A total of ***18 countries*** have seen conditions worsen leading to a ***downgrade***: Algeria, Argentina, El Salvador, Equatorial Guinea, Ghana, Honduras, Kazakhstan, Latvia, Madagascar, Mauritania, Philippines, Puerto Rico, Seychelles, Sudan, United Arab Emirates, Ukraine, Venezuela and Yemen.
  - Sudan, Venezuela and Yemen have been added to the ***Very High category***, joining Afghanistan, Congo DRC, Iran, Iraq, North Korea, Somalia and Zimbabwe.
  - ***Eight countries/territories*** have been ***upgraded*** to a lower risk level - Albania, Myanmar/Burma, Colombia, South Africa, Sri Lanka, East Timor, Vanuatu, Vietnam and the Hong Kong Special Administrative Region of the People's Republic of China.

Bottom Line: **Political and financial instability remain a feature of the business landscape in 2010 as a result of the recession.**

Source: Aon

A.M. Best: Country Risk Evaluation*

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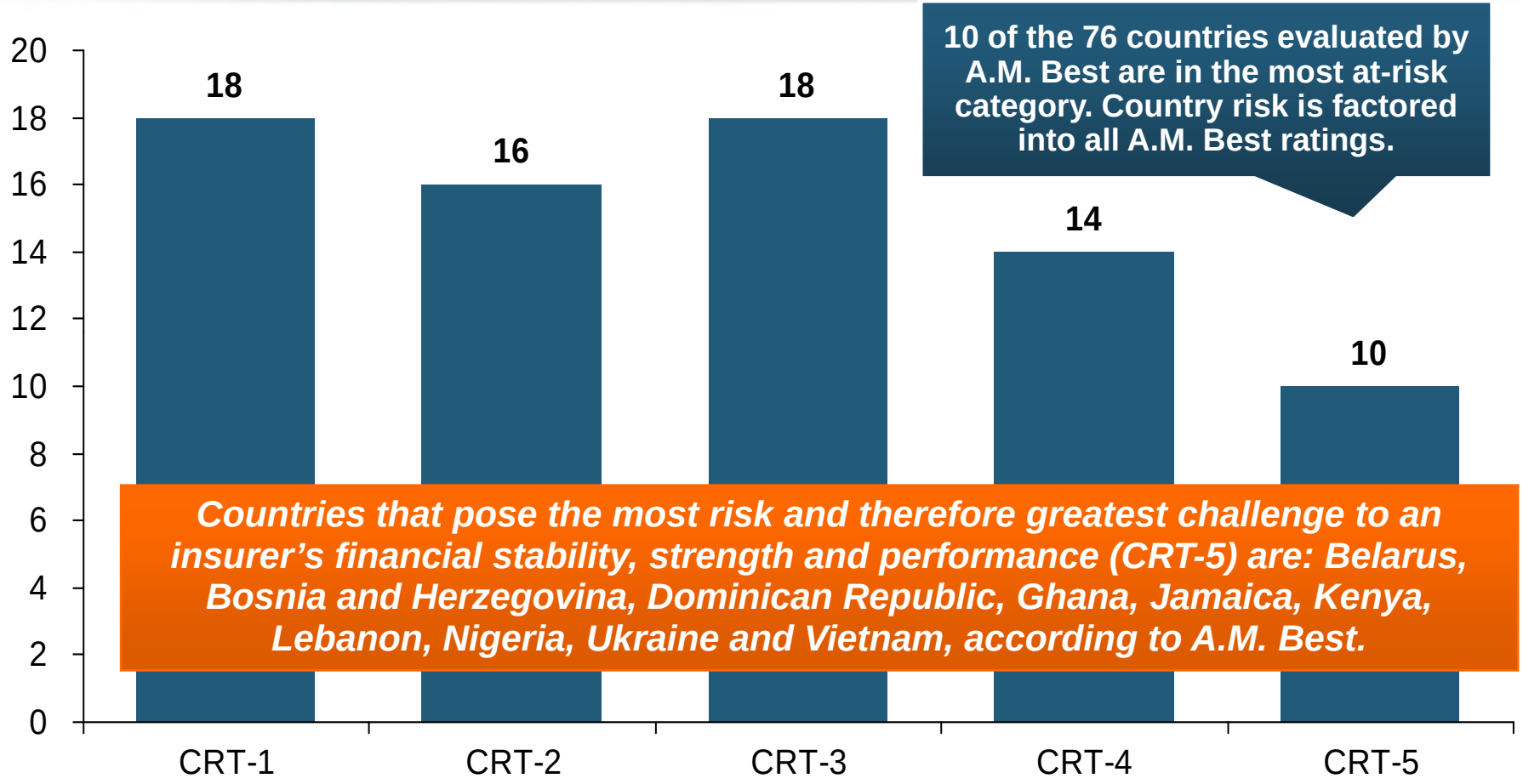

Countries that pose the most risk and therefore greatest challenge to an insurer's financial stability, strength and performance (CRT-5) are: Belarus, Bosnia and Herzegovina, Dominican Republic, Ghana, Jamaica, Kenya, Lebanon, Nigeria, Ukraine and Vietnam, according to A.M. Best.

***A.M. Best defines country risk as the risk that country-specific factors could adversely affect an insurer's ability to meet its financial obligations. Countries are placed into one of five tiers, ranging from Country Risk Tier 1 (CRT-1) denoting a stable environment with the least amount of risk, to Country Risk Tier 5 (CRT-5) for countries that pose the most risk and greatest challenge to an insurer's financial stability, strength and performance**

Source: A.M. Best., AMB Country Risk Report, Sept. 2009.

Countries by Insurance Risk Tier Rating

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CRT-1	CRT-2	CRT-3	CRT-4	CRT-5
Australia	Barbados*	Bahamas*	Antigua & Barbuda*	Belarus
Austria	Belgium	Bahrain	Brunei Darussalam	Bosnia and Herzegovina
Canada	Bermuda	*China*	Egypt	Dominican Republic
Denmark	British Virgin Islands*	Cyprus	*India*	Ghana
Finland	Cayman Islands*	Israel	Indonesia	Jamaica
France	Hong Kong	Kuwait	Jordan	Kenya
Germany	Ireland	*Malaysia*	Kazakhstan	Lebanon
Gibraltar*	Italy	Malta	Mauritius	Nigeria
Guernsey*	Japan	Mexico	Morocco	Ukraine
Isle of Man*	Liechtenstein*	Netherlands Antilles*	Panama	*Vietnam*
Luxembourg	Macau	Oman	Philippines	
Netherlands	New Zealand	Poland	*Russia*	
Norway	Slovenia	Qatar	Tunisia	
Singapore	South Korea	Saudi Arabia	Turkey	
Sweden	Spain	South Africa		
Switzerland	Taiwan	Thailand		
United Kingdom		Trinidad and Tobago		
United States		United Arab Emirates		

The fastest growing markets are pose a much greater risk to an insurer's stability, strength and performance

*Denotes countries to be considered "Special Cases" by A.M. Best

Source: A.M. Best., as of 4/13/10

Summary & Conclusions

- **The Global Financial Crisis Has Laid Bare the New World Economic Order**
  - There is no question that most of the world's largest economies (save China) suffered the most and continue to languish
  - The impacts of the crisis and associated impacts on insurance demand will be felt for the better part of a decade (2015-2016)
- **Following the Money Trail**
  - China and other newly industrialized nations create exposure and demand within their own borders
  - Many of the best insurance opportunities are associated with Chinese with *Outward* Foreign Direct Investment (FDI)
- **Insurance in the Age of Austerity**
  - Fiscal discipline in the largest insurance economies is a net short-term negative; Long-term positive
- **Economic Threats Remain Plentiful**
  - Generally manageable or have been exaggerated
- **The Unfortunate Nexus: Opportunity, Risk & Instability**
  - Future growth comes with greater risk than in the past

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