

The Peter J. Tobin College of Business

CENTER FOR EXCELLENCE IN ENTERPRISE RISK MANAGEMENT

The ERM Series:
The Coming U.S. Sovereign Debt and Dollar Crisis

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Enterprise Risk Management is an established but young practice at many organizations. Despite its youth, ERM has gained in importance. SEC Commissioner Aguilar recently noted that the current financial crisis may have cost \$13 trillion and he also stated that the importance of risk management cannot be overemphasized. Recent ERM work has highlighted the importance of identifying and measuring emerging risks. This white paper highlights one emerging risk that many should consider – the U.S. sovereign debt and dollar crisis.

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The Coming U.S. Sovereign Debt and Dollar Crisis

by Jean-Pierre Berliet

Continuing concern about the risk of another recession and the possibility of triggering deflation have caused the Department of the Treasury and the Federal Reserve Board to flood the economy with liquidity and to keep interest rates low. Nonetheless, the intermediate term outlook seems to be higher rates when the Federal Reserve Board reverses its present quantitative easing stance. Meanwhile, continuing growth in government debt can also be expected to result in higher inflation expectations, thereby causing markets to re-price Treasuries and force yields up. Additional pressure might also come from market doubts about the creditworthiness of U.S. sovereign debt.

The failure of the U.S. Government to pursue a credible deficit reduction strategy and reduce the growth rate of its indebtedness suggests that the creditworthiness concerns of investors will not abate and that the downgrading of U.S. sovereign debt by S&P in 2011 may be followed by further downgrading actions in the future. This possibility has put to rest the notion that yields on U.S. Treasuries can be used as benchmarks for default-free interest rates. In the present political context, this is more than a theoretical annoyance.

On its present course, it appears that the U.S. Government is manufacturing a sovereign debt crisis that could lead to a "systemic" breakdown of financial markets. Directors, Chief Executive Officers, Chief Investment Officers, Chief Risk Officers, and ERM Directors of insurance companies should be concerned and would be remiss if they did not seek to:

- Understand circumstances and forces that, if unchecked, will bring about a breakdown of financial markets
- Prepare contingency plans for their companies to withstand the ensuing financial and economic impact, and
- Work with other companies and national business organizations to forestall the disaster scenario that may already have begun to unfold.

Most importantly, these executives and business leaders need to appreciate that the occurrence of a systemic breakdown is unlikely to be triggered by a significant increase in the

probability of a default by the U.S. and that, therefore, the remoteness of such a default provides no comfort. Rather, a systemic breakdown is much more likely to result from a liquidity crisis caused by capital losses inflicted on financial institutions (including insurance companies) by volatility spikes in the U.S. sovereign debt market and contagion to other segments of the fixed income market. In a political context that renders constructive action for deficit reduction unlikely, U.S. sovereign indebtedness will only continue to grow and cause volatility to:

- Increase significantly, and sharply at times, in response to changes in inflation expectations and in credit spreads across major segments of the fixed income securities market, and
- Inflict significant losses on the capital of insurance and banking companies with significant investment positions in U.S. Treasuries and other fixed income securities.

Resulting impairments of capital positions, downgrading of insurance companies and banks, and regulatory actions will undermine confidence and increase participants' fears of default by counterparties. This fear may, in turn, render markets illiquid and bring financial transactions to a halt globally, with disastrous economic and political consequences.

Manufacturing a Systemic U.S. Sovereign Debt Crisis

The U.S. Government appears to be manufacturing a systemic debt crisis that is likely to:

- Plunge the country into another recession
- Force recapitalization of the insurance and banking industries and,
- Damage the credibility of the dollar as a reserve currency.

This crisis will result from the U.S. Government's continuing inability to reduce its deficit that it must, in turn, fund through issuance of bonds. In 2011, the cumulative amount of bonds outstanding exceeded 100% of GDP, approximately \$16 trillion, for the first time. Since then, U.S. sovereign indebtedness has continued to increase, both in absolute amount and in relation to GDP, generating fears that it might ignite inflation and cause interest rates on this debt to increase. Such increases in interest rates would make debt servicing more expensive, increase the deficit of the U.S. Government, and raise questions about the sustainability of credit ratings assigned to U.S.

sovereign debt.

These effects will increase the uncertainty facing investors, change inflation expectations, and change credit spreads. Together they will combine to increase volatility in the U.S. sovereign debt market and, by contagion, in other segments of the fixed income securities market. More importantly, it will change the inherent nature of volatility. Whereas volatility was understood to result from the interaction of independent random market forces in the past, volatility now will result principally and increasingly from the interaction of government decisions and policies, driven in part by the growing polarization of political debates about quantitative easing, tax policy, and entitlement issues. Volatility will be harder to anticipate, analyze, model, and will even be more difficult to hedge. As a result:

- Insurance companies (and banks) that invest in U.S. Treasuries and fixed income securities will suffer large losses that will reduce their earnings, weaken their capital positions, and possibly jeopardize their ability to meet risk adjusted capital requirements
- Increased volatility of insurance company earnings makes it more difficult to raise capital these institutions might need to recover from losses suffered on Treasuries and other fixed income investments.

If this sounds familiar, it is because it is very similar to the scenario under which the subprime debacle caused a meltdown of financial markets in 2007/2008. But it could be different and worse this time, because damage to the credibility of U.S. Treasuries will reduce the ability of the Federal Reserve Board and the U.S. Treasury to intervene forcefully.

Ironically, the probability and severity of a systemic risk event caused by a continued failure to reduce the deficit of the U.S. Government has been increased by two recent changes in the regulatory/oversight frameworks within which insurance companies and banks operate:

- First, valuation standards for assets have been moving closer to fair valuation principles used by the IASB, with the effect of increasing the volatility of reported earnings, accelerating recognition of the effect of gains or losses on capital, and possibly increasing the cost of capital of insurance companies.
- Second, imposition of increased risk-adjusted capital requirements, in line with increases

required under Solvency II and Basel III aggravates the capital strain resulting from operating or asset value losses.

The impact of these changes is less severe for life insurance companies that are still permitted to use statutory accounting principles. Note, however, that a rise in interest rates could cause policies to lapse, thereby causing companies to realize losses that would depress earnings and drain capital.

Working together, these changes in accounting standards and capital adequacy regulations are acting to raise risk-adjusted capital requirements for insurance companies. They call for insurance companies to reduce their writings or raise capital when their capital adequacy is strained. This is all good, except when companies are caught in a systemic market breakdown and when, therefore, capital becomes unavailable or prohibitively expensive. During a systemic breakdown, when markets are dysfunctional and capital cannot be raised, these institutional factors aggravate the severity of a crisis.

In the absence of credible action by the U.S. Government to rein in the deficit and restore confidence in the dollar as a store of value and in Treasuries as benchmarks of default risk free returns, volatility will only increase in all segments of the U.S. fixed income market.

Implications for Insurance Companies

Regulatory reforms implemented in the aftermath of the 2008 financial crisis were designed to prevent insurance companies from assuming more risk than prudent in relation to their capital. They are based on the assumption that insurance companies can measure risks they assume and that other risks (e.g. unknown risks, not modeled risks, or not modelable risks) can be contained by capital safety buffers. These enhanced regulations, however, cannot ensure that companies identify new systemic risks and develop appropriate mitigation strategies. It would be foolish, for example, for a company to assume that its risk models can adequately reflect the effect of a U.S. sovereign debt crisis and the resulting contagion impacting other segments of the fixed income market. These models have typically not been structured and calibrated to project the impact of such a crisis on capital adequacy. Insurance companies need to consider whether to upgrade models they

use to determine how to manage interest rate risk under such crisis scenarios.

In the present political context, it would seem important for executives of insurance companies to:

- Identify and assess consequences of growing government debt on their risk profile and capital position
- Take actions to reduce the adverse impact of interest rate spikes that will occur when inflation can no longer be ignored or when U.S. debt is downgraded further
- Position their business and strengthen their capital position against threats to their survival, and
- Act to hold politicians accountable and influence the national politics of deficit reduction.

At a minimum, insurance companies need to conduct stress tests to ascertain the impact of sharp volatility increases in the U.S. sovereign debt market. They need to focus especially on:

- Ensuring the adequacy of their capital position relative to their risk adjusted capital requirement, and
- Determining what measures are needed in anticipation of sharp increases in volatility to prevent downgrading or intervention by regulators, including development of sources of contingent capital and orderly restrictions on writing of new business.

Insurance companies would normally seek to avoid or transfer a high severity low frequency risk of this magnitude, but there are hardly any practical opportunities to do so in this instance.

Insurance companies might benefit, however, from reducing the duration and managing the convexity of their investment positions in fixed income securities, including U.S. sovereign debt, in anticipation of volatility spikes. This departure from a traditional ALM posture might expose them to greater interest rate risk but reduce capital losses triggered by sharp volatility spikes. In a political environment in which the U.S. Government seems unwilling or unable to reduce its deficit, this step could be beneficial.

Property & Casualty insurance companies, especially those that have significant involvement in long tail lines, need to consider that inflation could increase their future claim payments and render loss reserve inadequate. Under such conditions, an interest rate spike

scenario could have particularly severe consequences for companies that have deficient reserves and strained capital positions.

Call to Action

Although a new systemic crisis could be triggered by a U.S. sovereign debt crisis that could wipe out much of the equity capital of the insurance and banking industries, the U.S. Government seems to show little concern. It is acting as if it were confident to be able to prevent such a crisis or muddle through, as it did through the subprime crisis. By then, however, it may have so undermined its credibility and the value of the dollar that it may no longer be able to print its way out of another meltdown and the resulting breakdown of payment and settlement mechanisms. A new systemic crisis, triggered by a U.S. sovereign debt crisis, is conceivable and plausible.

This is a time for insurance executives and their banking industry colleagues to prepare their companies to weather a plausible storm. It is also a time for these leaders to build support for reforms required to spare this country the catastrophic financial and social costs of another systemic breakdown of financial markets. There may not be a better time for insurance industry leadership to undertake a lobbying effort aimed at holding politicians accountable and helping bring the U.S. household into order.

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