Greece and Puerto Rico Turmoil � Minimal Impact on U.S. Insurer Investments (6/29/2015)

Over the weekend, two announcements were released with negative implications relative to sovereign and municipal debt: one pertaining to Greece and the other Puerto Rico. While neither topic is new to the capital markets, both news releases were significant in that they carry negative implications in the ongoing turmoil within each area of focus.

Greece
After the Greek government's negotiations with creditors came to an impasse, it announced that Greek banks would close for six days and impose capital controls for the next week, until a national referendum scheduled to take place on July 5th. The referendum will determine whether the Greek government will accept austerity measures demanded by the country's creditors in exchange for additional aid. Furthermore, on Sunday, June 28, the European Central Bank froze emergency loans to Greek banks at their current level of €89 billion, and Athens is expected to default on a €1.55 billion (USD 1.73 billion) payment due to the International Monetary Fund, as it has lost international rescue loans for the first time in more than five years. The U.S. insurance industry's year-end 2014 exposure to Greece was modest, at $117.3 million ($7.3 million in bonds and $100 million in equities), with only $0.2 million in Greek sovereign debt. The exposure had been larger until 2011, at just over $1 billion, when the Greek government restructured significant portions of its debt, exchanging old bonds for newer ones at about 25 cents on the dollar. Greece's long-term sovereign debt rating is currently CCC/Caa3/CCC by Standard & Poor's (S&P), Moody's Investors Service (Moody's) and Fitch Ratings, respectively.

Besides direct Greek sovereign exposure, there is also potential concern for secondary impacts. Exposure to banks, especially European banks that are exposed to Greek sovereign debt, is one example. The total bond exposure of U.S. insurers to European banks was not substantial, at approximately $6.8 billion as of year-end 2014. The largest three exposures to non-U.S. banks were with Credit Suisse, HSBC Holdings PLC, and Deutsche Bank. In addition to direct investments in these aforementioned banks, U.S. insurers may also have some exposure to those banks as counterparties in derivatives transactions. The three largest European bank exposures based on notional value include Deutsche Bank, Credit Suisse and Barclays, however, the actual exposure to these banks is much smaller (i.e. due in part to netting, etc.), and should be well-collateralized.

Puerto Rico
The governor of Puerto Rico also announced over the weekend that the commonwealth's debt is unpayable. At $72 billion, Puerto Rico's debt load represents more than 70% of GDP. The island's economy has been suffering since 2006 with the closure of U.S. military bases, followed by the elimination of tax incentives that caused pharmaceutical companies and other manufacturers to leave. The resulting problem with unemployment (currently at 12%) has led the country's younger population to immigrate to the U.S. mainland, further shrinking the country's tax base and in turn exacerbating the situation. Puerto Rico's population has fallen 4.7% since 2010. Puerto Rico's municipal bonds had been considered attractive because they are exempt from federal, state and local income taxes in the U.S. The largest holders of Puerto Rico's bonds are municipal bond mutual funds. Direct ownership of bonds by U.S. insurers was

$1.4 billion as of year-end 2014. In addition, bond guarantors are estimated to have exposure of approximately $14 billion in par value of bonds. In general, U.S. insurer exposure to Puerto Rican bonds has been declining as the commonwealth's financial struggles have increased. The long-term debt ratings on the Commonwealth of Puerto Rico are currently CCC+/Caa2 by S&P and Moody's, respectively.

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