NAIC National Association of Insurance Commissioners & The Center for Insurance Policy and Research

Capital Markets Special Report

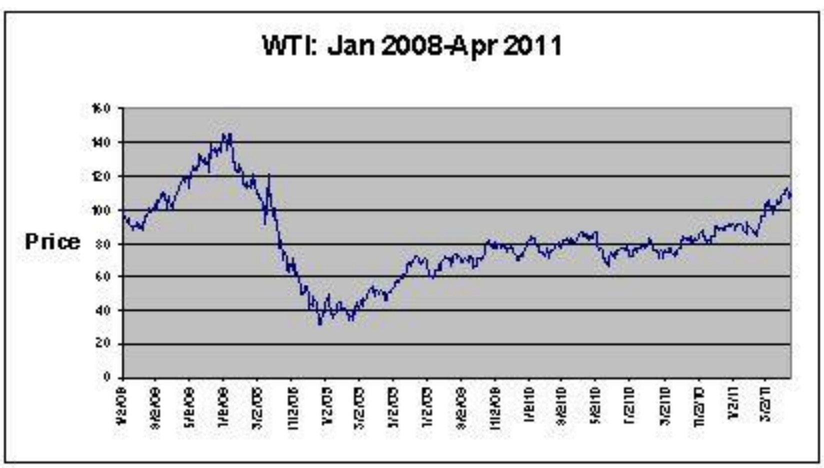
The **NAIC's Capital Markets Bureau** monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of US insurance companies. A list of archived Capital Markets Bureau Special Reports is available via the **index**

High Oil and Gas Prices: How Will They Affect Insurance Company Investments?

While oil prices have moderated somewhat in the past few days, dropping to $108.15 per barrel — based on the West Texas Intermediate Crude Oil Spot Price* (WTI) as of April 19, from a high of $112.79 on April 8 — both the current level and expectations of continued volatility are a significant concern. The International Monetary Fund (IMF) has said that oil prices above $100 a barrel would hurt the global economy. In particular, the IMF has already cut growth forecasts for the United States and Japan, which are two of the largest oil-consuming countries (China is the third). Oil prices first broke the $100/barrel mark in early March, having been on a steady rise for the past year; one year ago, on April 12, 2010, oil was approximately $84 per barrel.

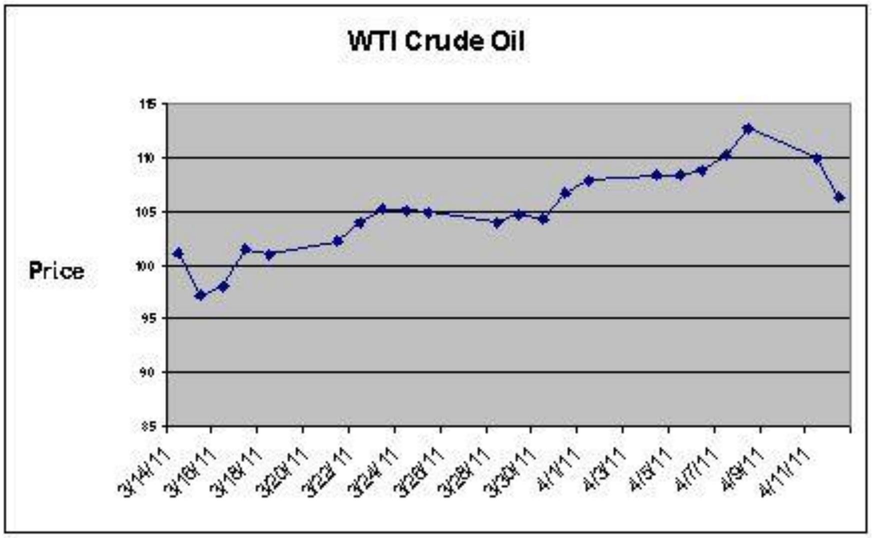
Historical Oil Prices

From 2002 to 2007, the price of oil steadily rose, peaking at $145.29 on the WTI in July 2008. In part, this rise was a result of fears that demand would outpace supply and that oil producers would not be able to keep up with the necessary rate of production. As a global financial crisis emerged and subsequent demand for oil decreased, the WTI oil price fell back to $31.41 in December 2008. However, in 2009, the price of oil was back on the rise, reaching almost $80 a barrel by year-end. During 2010, oil prices generally fluctuated between $65 to the mid-$80 range through mid-February 2011, due in part to signs of economic recovery and an expectation that oil demand would increase. At that time, unrest in the Middle East unfolded, and prices rose steadily through the $90 range, finally breaking $100 a barrel in early March 2011, around the time military action was taken on Libya. On April 8, 2011, a high of $112.79 a barrel on the WTI was reached.



Source: Bloomberg

Oil prices were steadily on the rise preceding the development of conflicts in the Middle East, as traders viewed improved economic conditions as a sign that demand for oil could rise. Continued turmoil, particularly in Libya and elsewhere in Northern Africa and the Middle East, has jeopardized access to oil in these regions. Unrest in Libya has cut their oil production by more than 70%, according to the Organization of Petroleum Exporting Countries (OPEC), of which Libya is a member. Other OPEC countries have pitched in to partially offset the loss by increasing their production. According to the International Energy Agency, oil from OPEC is responsible for approximately 40% of global oil supply, even after having made significant supply cuts in 2008. Although the United States is a large oil producer, it is still heavily dependent on oil imports. In the United States, 19 million barrels of oil are used each day by cars, trucks and aircraft.

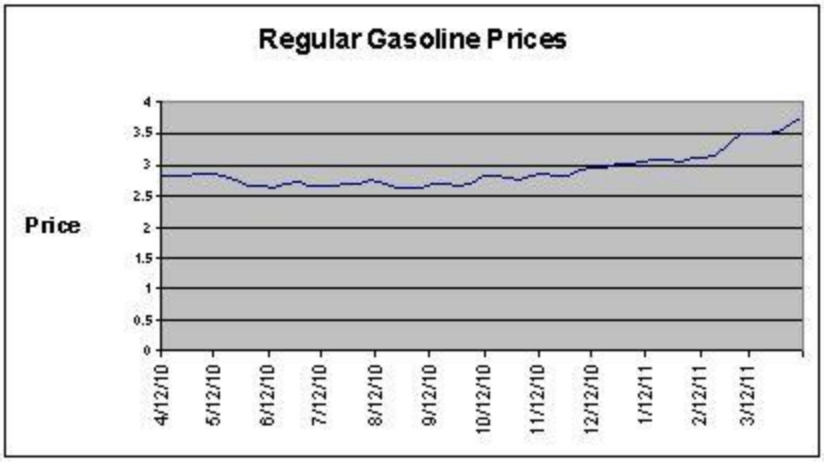


Source: Bloomberg

So far, industries and companies that depend on oil — such as auto, airline and other transportation sources — have not experienced any noticeable negative impact, as they typically purchase oil under long-term contracts or have established hedging programs. However, once these roll off, companies will be faced with paying the current higher prices. Consequently, the additional expense will likely have a negative effect on companies' income over time. This additional cost will need to be passed on to the consumers, which will stoke concerns over inflation.

General Economic Impact

With a rise in oil prices, a rise in gasoline prices almost always immediately follows. As of April 11, 2011, the average price of regular gas was $3.79 per gallon, representing an increase of 10.7 cents from the week prior and almost $1 higher than the same time last year. In some of the states, the price already exceeds $4 per gallon. Expectations among analysts are that they will go higher, both because of fundamental supply-demand dynamics and speculative factors. Despite the higher prices, consumer spending has yet to show real signs of being affected. However, longer term economic concerns — especially for more vulnerable parts of the consumer basket — have been noted.



Source: U.S. Energy Information Administration

If oil and gas prices continue to climb, consumers are likely to reduce their overall discretionary spending. As in the past, rising gas prices will result in consumers cutting back on their amount of driving and travel in general. This will have a significant impact on the summer travel economy.

The chief global economist for the Economic Outlook Group stated that, “spending on discretionary goods will be diminishing as the price of gasoline keeps moving higher.” Also, the vice chairwoman of the board of governors at the Federal Reserve Bank (Fed) also stated that, “rising energy and food prices were creating ‘significant hardships’ for many people and the Fed was watching the effect on inflation.”

According to Moody’s Investors Service, which recently changed its outlook for the global exploration and production industry to positive from stable, “The unrest in the Middle East and North Africa, and uncertainty over political changes there, should keep crude at premium prices over the near term.” In addition, analysts at Barclays Capital Commodities Research stated that high oil prices have not yet reduced demand too much among OPEC members or non-members. Even though U.S. oil demand remains relatively weak in terms of historical levels, it has not yet been significantly impacted by the high prices.

Impact on Industries

Almost every industry is somehow impacted by rising oil and gasoline prices — some more significantly than others. A few industries that are negatively affected are auto, aerospace and defense, hotels, transportation, shipping and electric utilities. For example, higher oil and gas prices result in consumers cutting back on buying cars, traveling by air and road (which impacts the leisure and lodging industries), as well as home heating and/or cooling that requires oil. In addition, higher oil and gas prices negatively affect corporations that rely on shipping for product transport. Because oil is a critical element in the manufacturing of polymers for plastics, prices will increase for those respective goods and/or services as the additional cost of oil is passed along to consumers.

On the other hand, there are a few industries that benefit from a rise in oil and gas prices. The oil and gas industry itself benefits, as higher prices translate into higher revenues. Companies that generate oil substitutes and alternative energy sources — such as coals, biofuels, natural gas and ethanol products — might be viewed as an inexpensive alternative to oil, so they stand to profit, as well. The same is true for companies that provide “green energy” services. Lastly, in an attempt to reduce utility costs at home because of rising oil prices, insulation companies usually experience an increase in sales of fiberglass and polyurethane products.

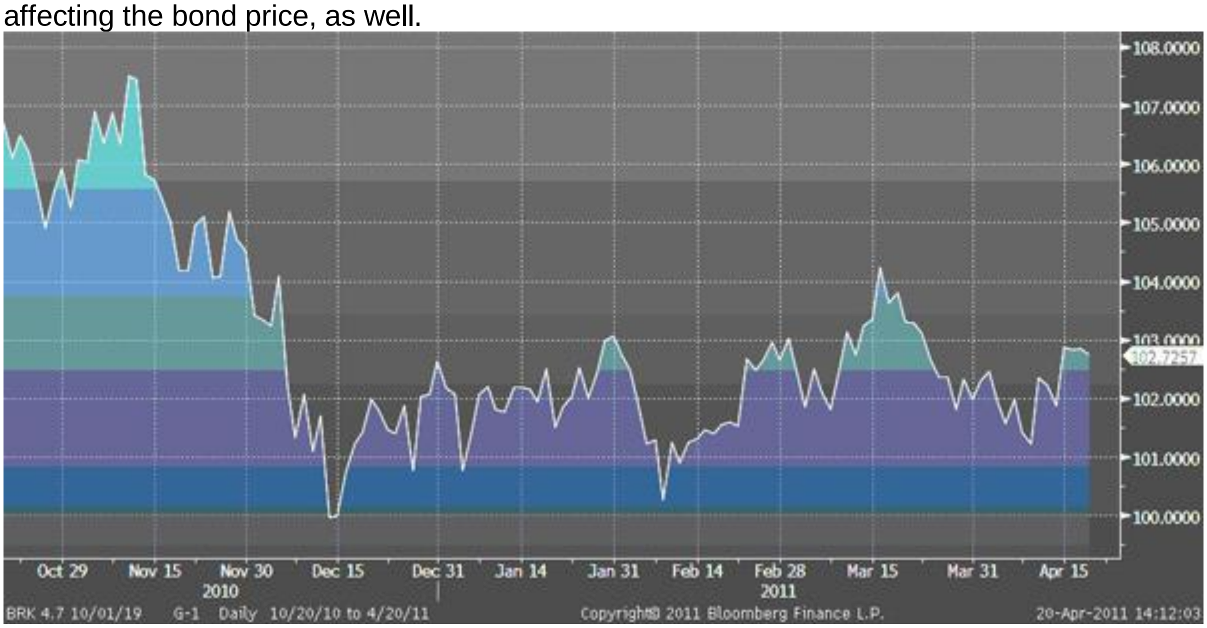
As of year-end 2010, insurance industry exposure to a few of these industries, in terms of bonds and common stock, were as follows:

($ in millions)	Total Bonds	Total Common Stock
Utilities	$196,236.0	$2,550.3
Oil & Gas & Equipment	102,657.1	13,747.2
Transportation & Shipping	39,697.4	1,530.0
Aerospace & Defense	25,671.7	1,393.4
Auto	7,270.1	879.2
Hotels	1,572.9	184.6

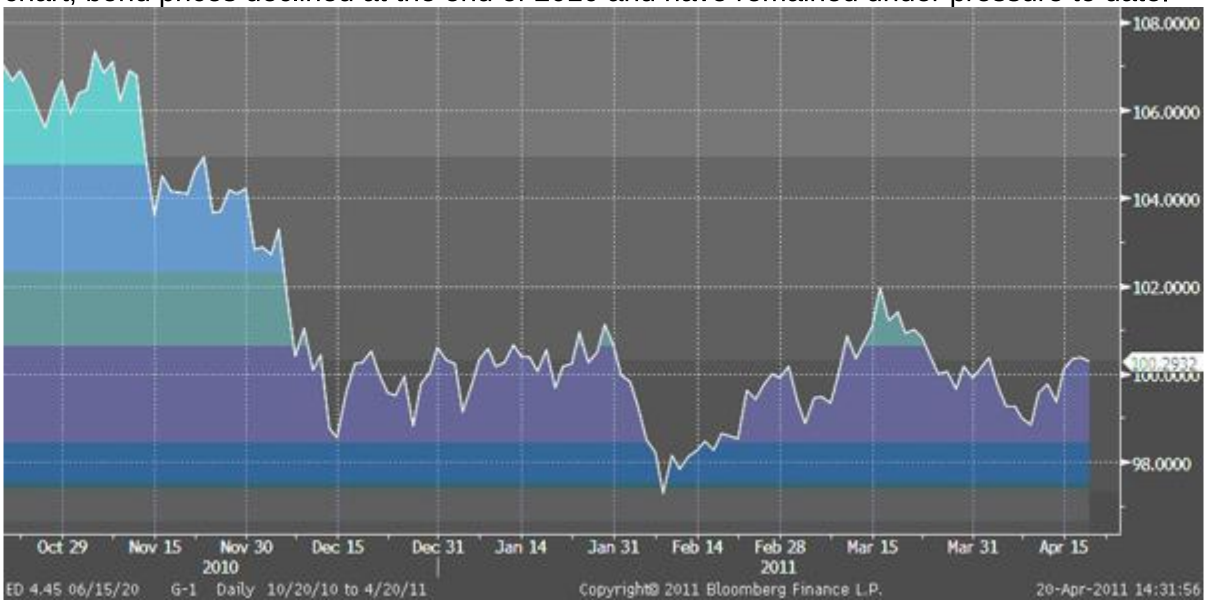
Future Impact

Some industry analysts expect the price of oil to continue to rise as Middle Eastern turmoil persists and possibly spreads, which could hurt future production and supply, even though the overall 2011 demand forecast for oil has been reduced by OPEC. Other industry analysts claim to have evidence that the United States has begun to decrease its demand for oil as higher energy prices strain consumer budgets, which will eventually bring down oil and gas prices. In the short-term, the price of oil and gas might fluctuate, but, in the longer term, the progress of the U.S. economic recovery, along with the status of the turmoil in oil-producing nations, will in part influence the direction of oil and gas prices.

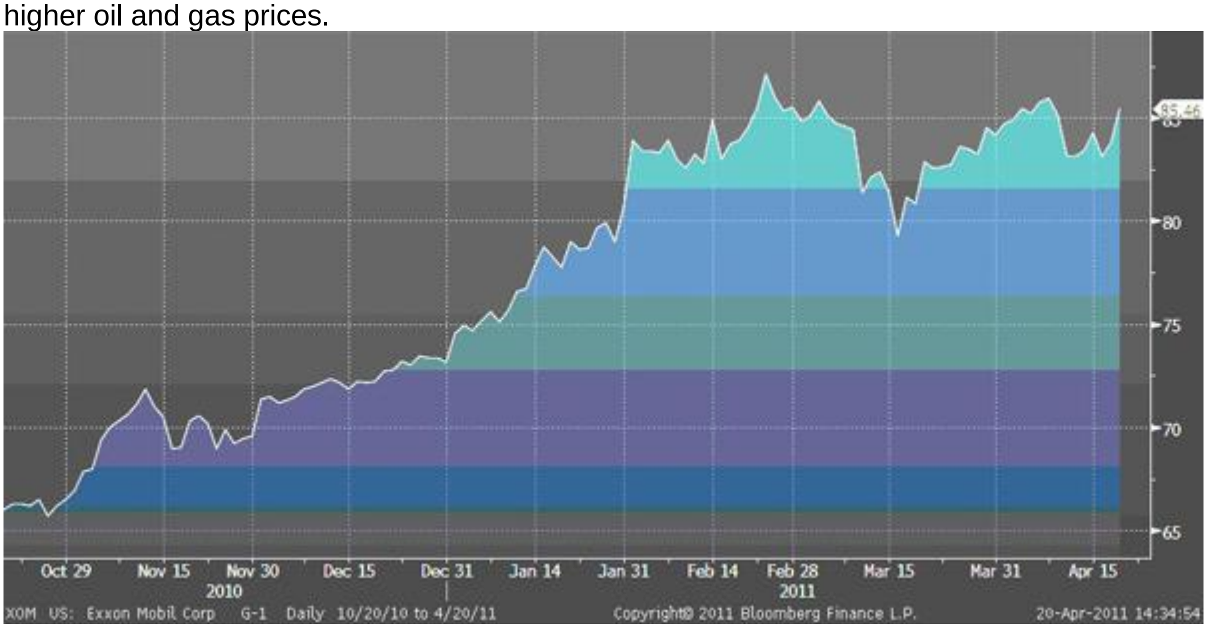
Although it might be too early to see the impact of higher oil and gas prices on issuer bonds, a look at issuer bond prices could provide some insight. The chart below graphs bond prices for the past six months for a Burlington Northern 2019 intermediate bond. Burlington Northern, a leading railroad company that provides transportation throughout the United States, was one of the insurance industry's top issuers in the transportation and shipping sector. It is heavily dependent on oil and gas to operate its transportation system and would, therefore, be negatively impacted by higher oil and gas prices. Bond prices declined significantly at the end of 2010 and have remained under pressure to date. The decline in bond prices can possibly be partially attributed to the markets expecting lower earnings in the future due to higher costs for fuel. It should be noted, however, that there could possibly be a number of other factors affecting the bond price, as well.



Another example is Consolidated Edison, a regulated utility in the New York City area and one of the insurance industry's top issuers in the electric utilities sector. Consolidated Edison heavily relies on fuel to operate its extensive system. The chart below graphs bond prices for the past six months for a Consolidated Edison 2020 intermediate bond. Similar to Burlington Northern's chart, bond prices declined at the end of 2010 and have remained under pressure to date.



Stock prices can also provide some insight into the impact of oil and gas prices. Exxon Mobil, one of the world's largest international oil and gas companies and one of the insurance industry's top issuers in the oil and gas sector, has been a beneficiary of higher prices. The stock has increased more than 15% since year-end 2010, partially reflecting the benefit of higher oil and gas prices.



The Capital Markets Bureau will continue to monitor the effect of oil and gas prices on insurance company investments and will provide updates as appropriate.

* The WTI is one benchmark that is used to price oil and is a light, sweet crude oil produced in the United States and delivered in Midland, Texas. Prices for WTI are quoted at Cushing, Oklahoma, which is a major crude oil shipment point that has extensive pipeline connections to oil producing areas and Southwest and Gulf Coast-based refining centers. Another major benchmark is the North Sea Brent Crude (Brent), which is a light, sweet oil produced in the North Sea with most of it being refined in Northwest Europe. Brent can be thought of as a

benchmark oil for Europe. There are other commonly used oil benchmarks, such as Saudi Light Crude Oil. Each benchmark requires different refining methods and capacities. Oil prices are quoted using one of these benchmarks, or using a basket that includes all of them.

April 15, 2011
Major Insurer Share Prices

		Close	Change % Week	Change % QTD	Change % YTD	Prior Week	Prior Quarter	Prior Year
Life	Aflac	$52.25	(2.6)	(1.0)	(7.4)	$53.66	$52.78	$56.43
	Ameriprise	61.61	(2.1)	0.9	7.1	62.93	61.08	57.55
	Genworth	12.26	(5.6)	(8.9)	(6.7)	12.99	13.46	13.14
	Lincoln	28.87	(3.1)	(3.9)	3.8	29.79	30.04	27.81
	MetLife	43.96	(1.3)	(1.7)	(1.1)	44.53	44.73	44.44
	Principal	31.40	(1.0)	(2.2)	(3.6)	31.72	32.11	32.56
	Protective	25.74	(3.6)	(3.1)	(3.4)	26.70	26.55	26.64
	Prudential	61.00	(2.1)	(0.9)	3.9	62.28	61.58	58.71
	UNUM	25.69	(2.4)	(2.1)	6.1	26.31	26.25	24.22
PC	ACE	$65.88	0.1	1.8	5.8	$65.79	$64.70	$62.25
	Axis Capital	35.82	(1.2)	2.6	(0.2)	36.24	34.92	35.88
	Allstate	31.41	0.0	(1.2)	(1.5)	31.40	31.78	31.88
	Arch Capital	101.93	(0.6)	2.8	15.8	102.57	99.19	88.05
	Cincinnati	32.18	(2.2)	(1.9)	1.5	32.92	32.79	31.69
	Chubb	61.87	(0.4)	0.9	3.7	62.12	61.31	59.64
	Everest Re	91.14	(1.6)	3.4	7.5	92.58	88.18	84.82
	Progressive	21.43	0.8	1.4	7.9	21.26	21.13	19.87
	Travelers	59.80	0.4	0.5	7.3	59.58	59.48	55.71
	WR Berkley	31.67	(0.4)	(1.7)	15.7	31.80	32.21	27.38
	XL	24.47	(2.9)	(0.5)	12.1	25.19	24.60	21.82
Other	AON	$52.47	(1.5)	(0.9)	14.0	$53.27	$52.96	$46.01
	AIG	33.46	(3.0)	(4.8)	(30.7)	34.49	35.14	48.27
	Assurant	37.91	(0.2)	(1.6)	(1.6)	37.98	38.51	38.52
	Fidelity National	14.94	1.4	5.7	9.2	14.73	14.13	13.68
	Hartford	26.80	(1.4)	(0.5)	1.2	27.17	26.93	26.49
	Marsh	29.52	(1.8)	(1.0)	8.0	30.07	29.81	27.34
Health	Aetna	$37.43	1.9	0.0	22.7	$36.75	$37.43	$30.51
	Cigna	44.48	3.1	0.5	21.3	43.13	44.28	36.66
	Humana	70.78	0.9	1.2	29.3	70.13	69.94	54.74
	United	44.98	1.4	(0.5)	24.6	44.38	45.20	36.11
	WellPoint	69.41	0.7	(0.5)	22.1	68.95	69.79	56.86
Monoline	Assured	$17.60	17.9	18.1	(0.6)	$14.93	$14.90	$17.70
	MBIA	10.48	9.6	4.4	(12.6)	9.56	10.04	11.99
	MGIC	8.76	(3.8)	(1.5)	(14.0)	9.11	8.89	10.19
	PMI	2.20	(15.4)	(18.5)	(33.3)	2.60	2.70	3.30
	Radian	6.28	(4.0)	(7.8)	(22.2)	6.54	6.81	8.07
	XL Capital	24.47	(2.9)	(0.5)	12.1	25.19	24.60	21.82

April 15, 2011
Major Market Variables

		Close	Change % Week	Change % QTD	Change % YTD	Prior Week	Prior Quarter	Prior Year
Dow Jones Ind		12,341.83	(0.3)	0.2	6.6	12,380.05	12,319.73	11,577.51
S&P 500		1,319.68	(0.6)	(0.5)	4.9	1,328.17	1,325.83	1,257.64
S&P Financial		217.27	(2.0)	(1.6)	1.2	221.70	220.71	214.77
S&P Insurance		191.70	(1.2)	(1.7)	1.8	194.07	194.96	188.22
US Dollar $			Change %			Prior		
	/ Euro	$1.44	(0.4)	1.9	7.8	$1.45	$1.42	$1.34
	/ Crude Oil bbl	109.66	(2.8)	2.8	18.9	112.79	106.72	92.22
	/ Gold oz	1,485.30	0.8	3.2	4.5	1,473.40	1,438.90	1,420.78
Treasury Ylds %		%	Change			%	%	%
	1 Year	0.23	(0.03)	(0.05)	(0.04)	0.27	0.28	0.27
	10 Year	3.41	(0.17)	(0.06)	0.12	3.58	3.47	3.30
	30 Year	4.47	(0.17)	(0.04)	0.13	4.64	4.51	4.34
Corp Credit Spreads -bp			Change %			Prior		
	CDX.IG	81.47	0.0	(2.8)	(4.2)	81.45	83.81	85.00

April 15, 2011
Major Insurer Bond Yields

	Company	Coupon	Maturity	Price			Spread	
				Current	Change	Yield	B.P.	Change
Life	Aflac	8.500%	5/15/2019	$121.63	$1.32	5.18%	212	2
	Ameriprise	5.300%	3/15/2020	$107.47	$1.62	4.28%	103	(1)
	Genworth	6.515%	5/15/2018	$100.43	$0.40	6.44%	354	14
	Lincoln National	8.750%	7/15/2019	$127.38	$1.48	4.69%	158	(2)
	MassMutual	8.875%	6/15/2039	$138.00	$3.61	6.05%	158	(3)
	MetLife	4.750%	2/15/2021	$100.95	$1.55	4.63%	120	0
	Mutual of Omaha	6.800%	6/15/2036	$103.29	$8.70	6.53%	223	(57)
	New York Life	6.750%	11/15/2039	$114.92	$2.33	5.69%	121	4
	NLV Financial	7.500%	8/15/2033	$115.67	$1.49	6.19%	205	5
	Northwestern Mutual	6.063%	3/15/2040	$106.51	$2.54	5.61%	109	1
	Pacific Life	9.250%	6/15/2039	$132.44	$2.56	6.68%	221	2
	Principal	6.050%	10/15/2036	$104.08	$2.36	5.74%	141	(1)
	Prudential	4.500%	11/15/2020	$98.81	$1.39	4.66%	128	2
	TIAA	6.850%	12/15/2039	$114.49	$2.89	5.81%	131	(1)
P&C	ACE INA	5.900%	6/15/2019	$111.56	$1.45	4.21%	110	(0)
	Allstate	7.450%	5/15/2019	$120.05	$1.32	4.46%	140	3
	American Financial	9.875%	6/15/2019	$124.11	$2.04	6.08%	299	(5)
	Berkshire Hathaway	5.400%	5/15/2018	$110.82	$1.11	3.65%	80	3
	Travelers	3.900%	11/15/2020	$95.66	$1.25	4.46%	109	2
	XL Group	6.250%	5/15/2027	$98.10	$0.64	6.44%	258	14
Other	AON	5.000%	9/15/2020	$102.16	$1.41	4.71%	137	3
	AIG	5.850%	1/15/2018	$104.89	$1.16	4.99%	223	3
	Fidelity National	7.875%	7/15/2020	$111.25	$0.00	6.25%	422	18
	Hartford	5.500%	3/15/2020	$102.94	$1.33	5.09%	184	1
	Marsh	9.250%	4/15/2019	$126.66	$1.82	5.14%	202	(6)
	Nationwide	9.375%	8/15/1939	$124.45	$1.92	7.32%	286	2
Health	Aetna	3.950%	9/15/2020	$97.49	$1.55	4.28%	92	(2)
	CIGNA	5.125%	6/15/2020	$104.94	$1.43	4.46%	113	0
	United Healthcare	3.875%	10/15/2020	$96.00	$1.43	4.40%	102	(1)
	Wellpoint	4.350%	8/15/2020	$100.11	$1.32	4.33%	100	0

Questions and comments are always welcome. Please contact the Capital Markets Bureau at **CapitalMarkets@naic.org**.