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Bubble Risk Bulletin
MAY 2011

The Society of Actuaries (SOA) has brought together several leading enterprise risk management (ERM) actuaries to identify the top 11 concentrated areas of risk in 2011 and provide insight on how ERM programs can be used to hedge against those systemic risks. With rigorous training in identifying, managing and mitigating risk, actuaries are well-equipped to discuss the areas of risk that need attentions as we work to rebuild the financial system post-crisis.

Spiking Oil Prices – Signaling a Double Dip Recession?

Given the recent backdrop of exploding oil prices and corresponding skyrocketing prices at the gas pump, corporate risk managers were on the mark when citing oil price shock as the number one emerging risk that will have the greatest impact over the next few years. In a recent survey published by the Society of Actuaries on emerging risks, 40% of risk managers cited oil price shock as one of their top 5 emerging risks, while 40% and 36% of the risks chosen came from the categories of economic and geopolitical risks. These areas interact in ways tied very closely to an oil crisis. (Society of Actuaries, Emerging Risks Survey, 2010)

While spiking oil prices may be front and center for investors, politicians, and consumers, alike, scant few have spoken about the potential for runaway prices to usher in a double dip recession. But that is exactly what actuary Gail Tverberg, an expert on the impact of oil production and consumption on the economy, is warning. Rising oil prices mean consumer cutbacks on discretionary purchases and eroding profit margins for businesses, which in turn means the next recession may be closer than we think.

Risk managers are on alert, as consumer cutbacks and falling profit margins will contribute to increasing unemployment, higher default rates on loans of all types, and a continuation of (or worsening of) falling home prices, likely extending to commercial property prices. Compounding matters, financial institutions may again need federal assistance, but unlike the bailouts of the past few years, governments will be less equipped to offer assistance. Ultimately, the aforementioned events would likely lead to decreasing tax collections, worsening the precarious budget balancing efforts of struggling federal and local governments.

What does this mean for the economy and what systemic risks does the oil price shock forebode? For one, notes Bob Wolf, actuary and staff fellow at the Society of Actuaries, while quantitative easing (QE2) may be scheduled to end in June, the confluence of events around an oil price shock may very well lead to QE3 and QE4 if the economy reverts towards another recession. QE2 has held oil prices up, just as it has pushed the value of the dollar down. When other countries raise interest rates it pushes the value of the dollar down as well, which tends to hold up the price of oil. Eventually, though, an artificially created bubble will burst.

Of course, no one can predict with certainty how all of these forces will play out, but actuary Max Rudolph, who led the Society of Actuaries Emerging Risk Survey, notes that this is exactly the role that risk managers must play. By determining what emerging risks such as spiking oil prices mean for our economy, scenarios can be developed that help corporations and consumers to make better decisions both now and tomorrow.

Issues that Actuaries Gail Tverberg, Max Rudolph & Bob Wolf Can Address Include:

- What near-term and long-term risks associated with spiking oil prices should companies be preparing for?
- Is the risk of rising oil prices going to be perpetuated by exploding demand in countries like China and India, where per capita oil consumption continues to rise?
- How closely correlated are unemployment and rising oil prices? How great a risk do rising prices pose to the job recovery?

For more information, please contact:

Lisamarie Lukas
Society of Actuaries
847.706.3566
llukas@soa.org

Amanda Pullins
Burson-Marsteller
312.596.3479
Amanda.pullins@bm.com

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