

Insurance Executive Review

Market Commentary on Current Developments within the P&C Insurance Industry

Wall Street Creates Products of Mass (Financial) Destruction

WHEN DID IT ALL START?

It all started with the “American Dream” of home ownership and is now playing itself out with the Wall Street bloodbath. To some it was the real estate bubble of inflated home prices that was the primary problem leading to the eventual current credit crises and financial institution failures. But the constant rise in real estate values in many parts of the country was more a symptom than the disease. There were simply too many buyers in the market and some of them, from a financial perspective, should not have been there. The extending of mortgage credit to those not yet able to meet the usual mortgage burden was overcome by lowering the qualifications for such “sub-prime” buyers. This coupled with devising new low cost “adjustable” instruments gave these buyers a false sense of security as it seemed the underlying market values could go nowhere but up. These conditions were bad enough but along came the financial wizards who could help banks package these mortgages into a “security wrapper”, get them rated as investment grade and even get the potential default risk “insured” if necessary. So as the financial machine churned out more mortgage credit capacity for the banks to put to use, so too more entry level buyers came into the market for homes. That spiral continued until the economy driven by consumer spending hit a wall. Inflationary commodity and energy prices along with unemployment escalations caused housing price weakness with ultimate declines. That triggered lots of bad things!

BUYER BEWARE?

It is generally true that in any given transaction the seller is working with more information than the buyer. In the height of the mortgage market activity many new subprime homeowners agreed to mortgage terms well beyond their understanding of the implied risks and in some cases through fraud and deception on the part of bank intermediaries. At the other end of the mortgage spiral were investors (including investment banks and their customers) that were spread around the globe. The demand for these asset backed securities was at a fever pitch, feeding off of the continuing surge in real estate values. Even credit agencies got into the act with strong ratings and or credit default insurance. But as in any open market there can be an imbalance in the information between the buyer and seller, a theory which suggests that the lesser quality paper can crowd out higher quality instruments over time. The mortgage and credit banking industry generally is more aware of the quality, credit risk, payment stream, collateral support, default rate and other characteristics of each particular credit portfolio than is the buyer. The financial impact hits home when the buyer realizes his information/expectation is incomplete and any guarantee (rating or insurance) is uncertain. When sellers can no longer find buyers the fluidity of the market becomes impaired. Not only do new deals stop but all existing credit portfolios are subject to re-evaluation

WHERE ARE THE TITANS OF WALL STREET?

The investment banking community has been dominated by Morgan Stanley, Bear Stearns, Lehman Brothers, Merrill Lynch and Goldman Sachs but virtually all of these institutions are in disarray via bankruptcy, merger or in active negotiations. These 5 institutions accounted for a combined market capitalization of \$237.22 Billion as of January 1 of this year and by September 19 that valuation was less than \$100 Billion. The primary movers in the mortgage market and historically considered as our first line of defense for industry standards, was Fannie Mae and Freddie Mac now controlled by the Federal Government after being on the verge of collapse. Equity in

these two entities was held by many including the insurance industry said to have a \$4 Billion stake. The global fallout from this credit crisis is estimated to have cost an estimated reduction of \$800 Billion - \$1 Trillion in asset valuations. Credit markets are frozen which puts economic activity at a standstill and triggers a lack of confidence on equity market valuations. Although the federal government tries to restore liquidity it still searches for a universal approach such as using some form of a "Resolution Trust #2" that might be the silver bullet solution. At least it will replace the piecemeal solution that hasn't worked to date.

THE "TOO BIG TO FAIL" SYNDROME

This statement often characterized the view of AIG as the global insurance and financial services powerhouse operating in 130 countries around the world. While insurance services were a particularly strong business segment for AIG with an 11% market share of US commercial risk business, we now know how this business was overshadowed by the financial derivative, credit default swaps and other credit risk instruments. It was thought that AIG's business was so diversified both geographically and by product segment that any failure potential was out of the question. In fact AIG didn't fail in the typical sense. Rather it was the inability of AIG to meet new collateral calls and a failure of confidence that AIG could meet its future obligations which were based upon the uncertainty in mortgage defaults, true asset valuations, rating agency downgrade triggers and the general credit market freeze on liquidity. AIG's risk assumption, much like MBIA and Ambac, was that it was only taking highly rated and highly protected slices of the CDS market and because of it's Triple A Rating counterparties were not asking for any collateral.....at least not until AIG's rating began to slip.

While AIG may have practiced good risk management in its core insurance underwriting business, perhaps there wasn't sufficient "enterprise risk management" work done in evaluating the risks AIG faced as a global financial business "Food Court" organization. With AIG's insurance dominance in certain markets, the current condition of competition and declining prices may be halted if that capacity becomes restricted or withdrawn by management design or customers looking elsewhere. Since the insurance operations might be sold, customers may not be comfortable buying insurance from a company whose ultimate parentage is uncertain. If AIG is not as competitive a market player as they were before this crisis, then withholding of capacity may cause prices to firm.

REGULATORY ISSUES

There is no doubt that new regulatory operating rules need to be updated across the entire financial industry spectrum and these should be thoughtfully undertaken so as not to be so restrictive as to interfere with an orderly and efficient market. On the matter of insurance regulation there is no doubt that state insurance regulations, not oversight, was effective in the AIG case. Regulations prevented the holding company from engaging in up-stream excessive dividends and/or loans and thereby depleting capital or the asset quality protecting policyholders. But state insurance regulation while allowing oversight and inspection of the insurance subsidiaries was unable to exercise that same oversight of the holding company which was based in New York. We think federal regulation if companies want a national charter can have effective regulation and oversight over both operating units as well as holding company activities. State insurance regulators don't have the jurisdiction or the capacity for that kind of oversight.



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