
Insurance Executive Review

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

Federal or State Regulation of Insurance Industry

... or can anyone be trusted to do a good job?

The National Association of Insurance Commissioners (“NAIC”) launched a campaign to discourage adoption of pending legislation that would create an optional national insurance charter thereby allowing carriers to operate in every state but only in providing commercial insurance products. The NAIC through its president Sandy Praeger back in August was reported trying to suggest that the failure of federal authorities to foresee and head off the subprime mortgage market was evidence that they should be trusted to oversee insurance. Ironically the state insurance regulators were also guilty of this same failure (as were others) in their oversight of bond insurers who contributed to off-loading these mortgages to investors as “insured” collateralized debt obligations (“CDO”). Insurance made these securities seem less risky. She also saw problems “in financial services solvency, but not in the insurance business.....our house is in order”. Although solvency regulation of insurance companies has improved we still have a good number of insolvencies taking place with an ever increasing cost burden. Since 1976 there have been 600 insolvent insurers over those 31 years and the state guaranty system has paid out \$12 Billion in claims and other costs with nearly \$5 Billion of that being in the last 6 years. Not exactly a crisis but still leaves much room for improvement.

SUBPRIME MARKET AND INSURANCE

The estimated worldwide write down related to the sub-prime mortgage market is now estimated at \$505 Billion and counting. The growth of this market was dependent upon many factors but central to expansion was the need to attract capital from sources that were not currently or directly involved in the traditional mortgage process. So financial institutions would package these mortgage obligations into CDO's to attract outside investors. In order to attract investors the institution would have the security obtain a rating and/or have the obligation of principal and interest insured by bond underwriters. Bond insurers such as MBIA, AMBAC and FSA were all well known for their insurance on municipal bonds and were themselves AAA rated by Standard and Poors. They quickly saw a new market opportunity for their guaranty product but now have seen their ratings drop to AA after capital raising efforts. FGIC is another bond insurer that saw its triple A rating downgraded to a level now considered junk status. In order to protect their municipal bond holders they transferred \$184 Billion of those bonds to MBIA for a commission of \$200 million that will help them settle significant CDO default obligations. Other new bond insurers were formed such as ACA Financial Guaranty in November 2006 targeting CDO's but is now under regulatory supervision in Maryland.

So if we rely on the “blame game” there is certainly enough to go around. With bond insurers writing \$2.4 Trillion of principal obligations of which \$800 Billion constitutes their CDO portfolio, should have been a sign to insurance regulators to take another look at the bond insurers risk based capital analysis and assumptions. It is be-

lieved by many that the sub-prime market went beyond its normal endpoint because the availability of insurance:

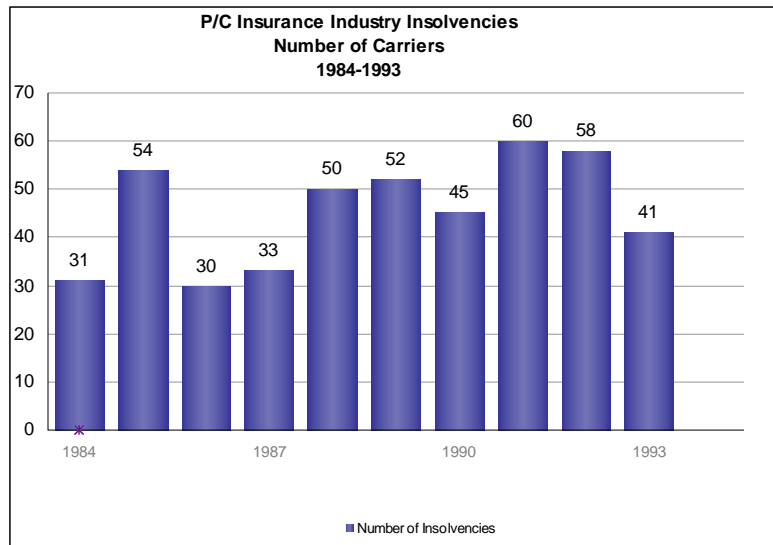
- Made the investment appear to be much less risky;
- Promoted confidence even among non-insurance regulators;
- Attracted new investors in the type of security they might not purchased;
- Encouraged the continuance and expansion of bad lending practices;
- Provided continued compensation along the mortgage food chain;
- Assumed regulators were making positive value/risk evaluations about this new business for bond insurers.

Regulators were as much to blame as any other federal or state agency. As one observer put it about the bond insurance market "They were our last line of defense against this getting out of hand and they failed us".

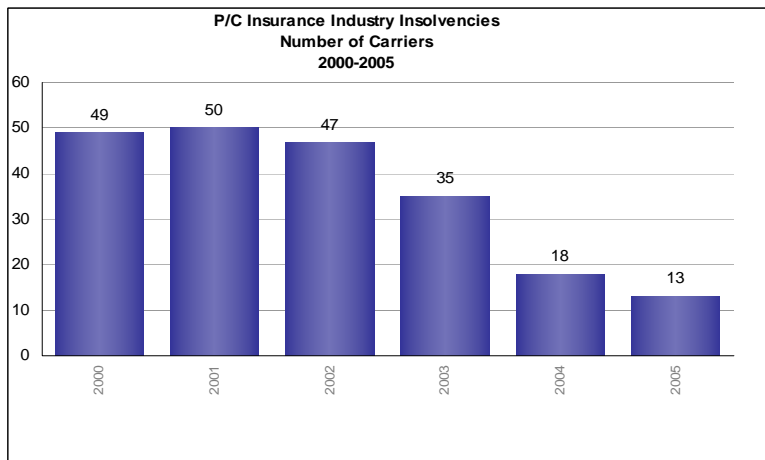
INSURANCE SOLVENCY.....HOUSE IN ORDER?

The regulation of insurer solvency has seen material improvement since 1992 when risk based capital (RBC) requirements were first introduced to the insurance industry much like those that applied to the banking industry years earlier. This followed near the end of the most dramatic period of insurer insolvency among insurers in the years 1984-1993 as more than 450 insurers became insolvent.

That 10 year period saw an average of 45 insurers per year coming under regulatory control. The overriding reason in 51% of the cases was the deficiency of claim reserves. The introduction of RBC rules has since played a major role in not allowing companies to continue in a financially impaired condition without recourse. While RBC rules allowed for more effective oversight (on the heels of a threaten federal intervention) it didn't completely eliminate the potential for future insolvencies.



Note: The number of insolvencies above counts all subsidiary insurance companies owned or controlled by the same group that came under regulatory control often domiciled in different states



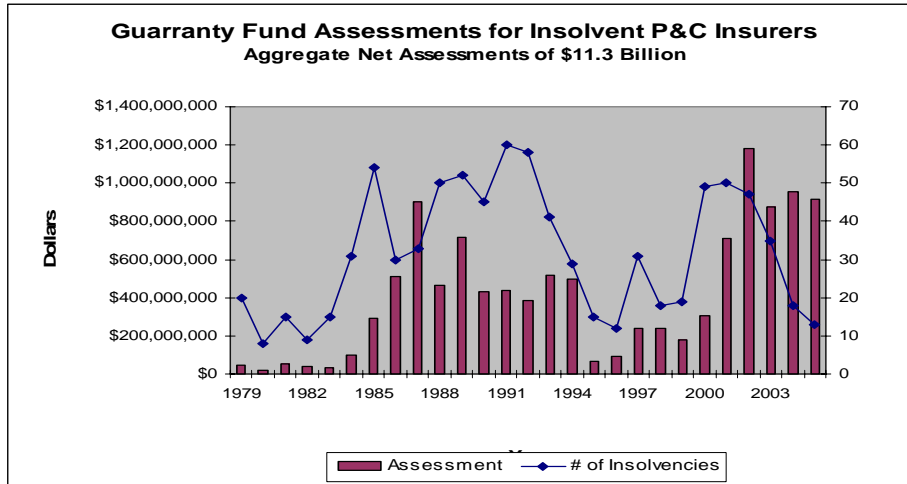
The period from 2000-2005 saw 212 insolvencies or an average of 35 per year with a number the result of the catastrophe event of 2001. Although the number (frequency) has improved the cost (severity) has not. The cost of these insolvencies, as measured by assessments* from state guaranty funds against the remaining solvent carriers, has materially increased over any prior period. This process has often been referred to as "we bury our own dead.....but it is becoming a lot more expensive!"

**State regulators can via State Guaranty Funds make assessments against solvent*

carriers for the cost of paying claim obligations of insolvent carriers as a result of a deficiency of funds from the estate of the defunct carrier provided the latter was an “admitted” carrier in that state. Surplus lines carriers who become insolvent are not covered by any guaranty fund except in the state of New Jersey. There are other exceptions as noted later.

INSOLVENCY COST UNDER STATE REGULATION

The cost of insolvencies as measured by the net assessments by state guaranty funds against solvent insurers has grown while the number of insolvencies on average has declined. In other words, the cost as a real measure of whether state insolvency regulation has its “house in order” is open to question.

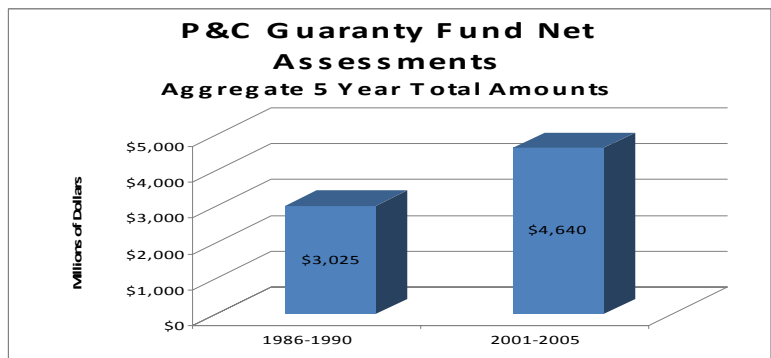
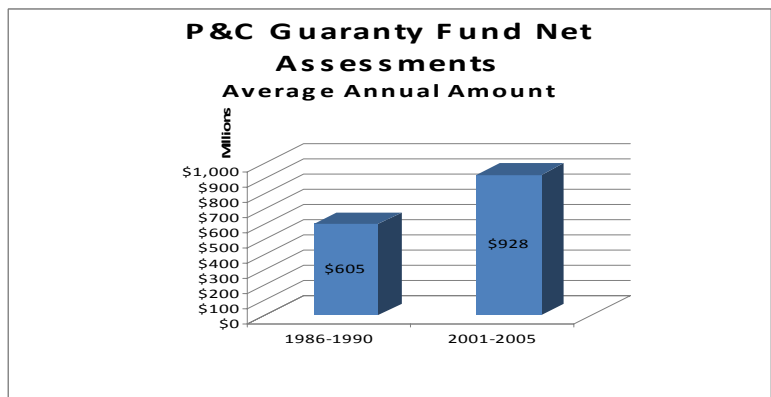


While the chart looks at an extended period of 26 years we can narrow our view to just the two periods covered in our earlier discussion which are shown below on an aggregate basis as well as the annual average costs.

State guaranty assessments have risen on average more

the 53% in 2000-2005 over a comparable period of 1986-1990 after RBC rules came into effect. So after 9 years of working with new RBC regulatory tools, solvency regulation at the state level still leaves a lot of room for improvement. It should be noted that the while assessments are but one measure of the cost of insolvency, the ultimate true cost is elusive. They do not include any of the following costs:

- Amounts owed claimants in excess of the guaranty fund limits on any one claim which varies by state and by type of coverage;
- Claims on policy coverage which are excluded (i.e. marine insurance);
- Claims against surplus lines insurers (except New Jersey);
- Cost of claimants/policyholders in filing claims against guaranty funds including legal expense;
- Cost of delays in actual receipt of claim amounts that may take years to recover;
- Loss of unearned premiums paid to the insolvent carrier;



- Claims denied to commercial policyholders who have a net worth exceeding a stipulated amount.

It is uncertain what amounts are contemplated by these items which are outside the guaranty assessments and there is no reliable way to track these supplemental costs. Improvements in reducing insolvencies and their related costs is still a work in progress at the state level and compliance with uniform federal standards just might be a step in the right direction. A fresh look at the required uniform insurance regulatory standards and the ability to implement them across all territorial jurisdictions is a compelling advantage over a piecemeal and at times disjointed approach of state-by-state regulation.

NEW REGULATORY VIEW

The NAIC has since August changed its view and now supports a slightly more limited version of the Feds creating an Office of Insurance Information which many believe will lead to federal supervision of commercial insurance. Not all state commissioners or in fact state legislators are in agreement with this position.

With the bailout of AIG we again saw finger pointing as that organization was better known for its insurance company operations than its financial products particularly Credit Default Swaps (“CDS”) run out of London. Back in 2000 the New York State Insurance Dept. (NYSID) determined that CDS instruments known as private market derivatives were “not insurance” and therefore not to be regulated as such. This CDS market has grown to be a \$62 Trillion market by most accounts and seems to have slipped federal regulation as well. So on September 23, 2008 the NYSID reversed itself and now states that some CDS contracts are insurance and can only be sold by organizations with an insurance license. This may be fine for contracts involving New York entities but has little effect elsewhere. That’s the difficulty with state based regulation in what is clearly a national business within a global financial market.

We need a regulatory system that must first understand how the market actually works before attempting to adopt rules of the road that can really be effective.

For more on Federal Insurance Regulation in Insurance see our newsletter “Here Comes the Feds” available on our website www.crmarketstrategies.com



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About the Author

CR Market Strategies Inc. (“CRMS”) was formed in January 2003 by Charles L. Ruoff, CPCU. Mr. Ruoff is President of CR Market Strategies Inc. an insurance marketing and risk management consulting organization based in Garden City, New York. Mr. Ruoff has been involved in insurance underwriting, international insurance brokerage and alternative risk management businesses having held executive management positions with Continental, AIG, Johnson and Higgins, Sedgwick James, and Acordia (Wells Fargo). He has been a speaker/panel member at numerous industry events during his over 40 years in the insurance industry including RIMS, CPCU and other conferences. His articles have appeared in many industry publications and is a member of the Advisory Board of St Johns School of Risk Management and Actuarial Science.
