

Insurance Executive Review

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

THE AVAILABILITY OF INSURANCE DISGUISED SOME OF WHAT WE NOW CALL “TOXIC ASSETS” BY DRESSING THEM FOR THE WALL STREET PARTY THE PARTY IS OVER BUT THE HANGOVER LINGERS ON!

We have seen the effects of excessive leverage within the financial community whether in direct borrowing, off-balance sheet financing, hybrid securitization or other devices that gave firms access to or the control of money from other than capital investors. This allowed firms to increase investment assets or off-load liabilities to others at significant multiples to the shareholder funds at risk. It further assumed that investment values at risk could be enhanced or hedged through the purchase of “default insurance” or minimized by reliance on acceptable credit ratings by recognized credit agencies. These considerations were driven from complicated models devised by economic theory of market asset pricing that in retrospect were not the “sure thing” that most believed them to be....the risks were not perfectly controlled.

LET’S BLAME THE ECONOMISTS

The collapse of financial markets and the worldwide recession might easily be blamed on the bursting of the U.S. residential real estate market bubble and the resulting meltdown of engineered financial products that supported inflow of liquidity to that market. In fact, it might be said that modern economic theory coupled with the complicated mathematical models that drove the demand for these financial products, were the primary reasons the conditions reached a catastrophic level. The economic “efficient-markets” theory held that the price of a financial asset at any time reflects all available information that is relevant to its value. Therefore, it could be argued that bubbles could not form or would not last, as new investors would find them and deflate them. This was the basis of financial engineering that designed complex mathematical models upon which derivatives and securitizations were based including intricate credit-default swaps and collateralized debt obligations. These models in practical use suffered from several defects:

1. overemphasis on recent input trends then historical data;
2. assumptions used reflected a more benign view of the world then reality suggested;
3. models being pushed to extremes by financial executives seeking market profits;
4. the lack of recognition on the potential correlation of two different types of assets;
5. the model used to determine the “value-at-risk” reflected inadequate volatility of asset prices and that prices between asset classes would be constant;
6. the belief that prices could not move away from fundamentals for any sustained period of time.

These models were primarily based on the assumption of the rationality of financial markets. There was another recent view of behavioral economic theory, that it is human nature to be over-confident about ones abilities and

to extrapolate recent trends into the future, a combination that may contribute to bubbles. This might also lead to becoming extremely risk-averse when a bubble does burst that would suggest model-driven selling by all the players. But the existence of insurance would be “icing on the cake” protecting against what the models suggested as minimal risk and insurers saw as an expanding market for their products of protection.

The overhaul of the financial market regulation has already begun and it is expected that political solutions will overshoot the needs of what is required in new regulations.

WHERE DID THE INSURANCE INDUSTRY STAND IN ALL OF THIS?

The insurance industry was not the central character in the overleveraging of the financial markets but could be described as a significant facilitator and modest participant in this market activity. In respect of facilitating the run

Mortgage Guaranty Insurance				
Year	Net Written Premiums	Growth Rate	Combined Ratio	Underwriting Profit
1999	\$ 3,095,621	3.9%	56.2	\$ 1,355,882
2000	\$ 3,411,356	10.2%	47.3	\$ 1,797,785
2001	\$ 3,738,058	9.6%	52.1	\$ 1,790,530
2002	\$ 3,987,772	6.7%	58.2	\$ 1,666,889
2003	\$ 4,285,447	7.5%	67.6	\$ 1,388,485
2004	\$ 4,323,071	0.9%	75.6	\$ 1,054,829
2005	\$ 4,454,711	3.0%	75.2	\$ 1,104,768
2006	\$ 4,565,899	2.5%	71.0	\$ 1,324,111
2007	\$ 5,192,104	13.7%	129.0	\$ (1,505,710)
2008*	\$ 5,150,000	-0.8%	261.0	\$ (8,291,500)

* Estimated by CR Market Strategies Inc

1999-2007 data from Insurance Information Institute

-up of the residential real estate market, it was the availability of Mortgage Guaranty (Default) Insurance that assisted the growing “less than prime” mortgage market.

The profitability of this business has shown a significant downward trend since 2000 culminating with disastrous results since 2007 reflecting the bursting of the real estate market bubble and widespread defaults. These insurers are now seeking relief through litigation suggesting that in some cases mortgage underwriting standards by financial institutions were ignored or at best compromised, either directly or in-

directly by mortgage brokers acting as their agents.

This mortgage guaranty market in 2007 was dominated by seven carriers and their reinsurers, who held 98% of the market for several years, suggesting that the extremely difficult underwriting market result was not absorbed by the general property casualty market but concentrated among a few specialist markets in this segment as noted in the diagram on the right:

These are the markets suffering the brunt of the mortgage default losses resulting from the downturn in the real estate market.

The secondary market involvement came from Financial Guaranty insurers who expanded their participation in the residential housing bubble through insurance of credit default obligations backing the marketing of “packaged” residential mortgage obligations that were hybrid securities marketed to investors. This market had the following historical financial results:

Mortgage Guaranty Insurance Groups/Companies 2007 Direct Premiums

	Direct Premiums Written	Market Share
MGIC Group	\$ 1,487,489,519	24.4%
Radian Group	\$ 1,026,923,234	16.9%
PMI Group	\$ 970,961,090	16.0%
AIG	\$ 788,734,840	13.0%
Genworth Financial	\$ 754,684,131	12.4%
Old Republic	\$ 637,957,000	10.5%
Collateral Holdings	\$ 339,006,491	5.6%
CUNA Mutual	\$ 81,101,368	1.1%
Others	\$ 321,281	0.1%
Total Direct Premium	\$ 6,087,178,954	100.0%

Financial Guaranty Insurance

Year	Net Written Premiums	Growth Rate	Combined Ratio	Underwriting Profit
1999	\$ 1,397,807	32.6%	30.1	\$ 612,239
2000	\$ 1,053,211	-24.7%	43.3	\$ 555,042
2001	\$ 1,219,399	15.8%	30.5	\$ 584,092
2002	\$ 1,834,174	50.4%	36.5	\$ 766,685
2003	\$ 2,507,763	36.7%	29.4	\$ 812,515
2004	\$ 2,133,599	-14.9%	44.3	\$ 520,598
2005	\$ 2,014,467	-5.6%	29.8	\$ 499,588
2006	\$ 2,163,324	7.4%	47.7	\$ 627,364
2007	\$ 3,038,889	40.5%	152.4	\$ (881,278)
2008	\$ 3,350,000	10.2%	305.0	\$ (6,867,500)

* Estimated by CR Market Strategies Inc

1999-2007 data from Insurance Information Institute

This market operated with a similar concentration of market participants as the Mortgage Guaranty insurers so the financial result was contained within a relatively few companies. The historical market participants are shown in the exhibit below:

These insurers have suffered similar rating downgrades as the Mortgage Guaranty markets as a result of their concentrated exposure to the residential market collapse. Several companies including AIG wrote financial guaranty products from company operations outside the US some of which would not meet our classical definition of "insurance" as the insured was not directly at

risk. These purchases insured a position on the direction of certain securities or commodities as a "bet" without being truly at risk.

WHERE DID IT ALL GO SO WRONG?

Mortgage insurance (k/a Private Mortgage Insurance or PMI) was historically required by mortgage lenders when the down payment on a residential purchase was less than 20% of the purchase price of the home. It protected the lender against the possible losses following default but the premium was paid by the homeowner as part of the monthly mortgage obligation. Wanting to extend the American Dream of homeownership Freddie Mack and Fannie Mae were encouraged to extend lending terms and were followed by the entire financial services industry. These events necessitated more than

ever the development of creative financing to support the growing market. An ever growing pool of buyers forced residential prices ever upward. This would tend to disenfranchise some buyers out of the market on the basis of affordability as their financial resources would be outpaced by the home price inflation. So PMI could allow these buyers into the market on the theory that the expected future increase value of the acquired home would provide greater equity that would make the default risk minimal and the existence of PMI redundant. Other creative finance methods were used in some cases to avoid the purchase of PMI as it was not a deduction for tax purposes but Congress changed that in 2006 which kept the "sub-prime" mortgage market moving forward rapidly. So the existence of PMI encouraged riskier lending practices which enabled greater expansion of real estate demand as more buyers became "eligible".

ATTRACTING CAPITAL TO INSURE REAL ESTATE GROWTH

The supply side of bringing more eligible buyers to the table could have been frustrated if not for the growth in attracting investor's capital to underwrite this financing. It would have been impossible for the mortgage financing industry to keep up with the funds needed to support this market unless outside financial assistance was

Financial Guaranty Insurance Groups/Companies 2007 Direct Premiums

	Direct Premiums Written	Market Share
Ambac Assurance	\$ 791,594,649	24.4%
MBIA	\$ 631,527,782	16.9%
Financial Security(FSA)	\$ 618,398,728	16.0%
PMI Group	\$ 306,101,620	13.0%
XL America	\$ 254,319,008	12.4%
Radian Grp.	\$ 193,075,167	10.5%
ACE Ltd.	\$ 150,057,759	5.6%
ACA Financial	\$ 95,907,150	1.1%
Others	\$ 76,935,808	0.1%
Total Direct Premium	\$ 3,117,917,671	100.0%

obtained. Wall Street to the rescue! It quickly became apparent that banks could package a large group of individual home mortgages into a mortgage-backed security that could be marketed to investors interested in the amount of cash flow income that could be generated. Banks would continue to service these mortgage obligations while off-loading major risks, lawyers would earn fees and Wall Street could reap commissions selling these collateralized debt obligations. Those buying the protection were sometimes the architects of the underlying deals that ultimately were marked down in value.

The structure of these obligations became complex as groups of mortgages were divided into tranches for packaging to market. Rating agencies using much of the same extrapolation of data techniques discussed earlier would, for a fee paid by the issuer, give a credit rating to assist in the marketing effort. To further aid in the marketing effort would be the Financial Guaranty insurance market, who had historically concentrated their efforts on providing default coverage to the municipal bond market. This had allowed municipalities to offer lower cost debt obligations with greater market appeal. These credit enhancements backed by triple A rated financial guaranty insurers caused these mortgage-backed and related credit investments to look appealing to a worldwide market eager to participate in the real estate party. That all disappeared as did their credit ratings with the real estate market downturn.

THE INSURANCE HEADACHE CONTINUES

As noted in my Newsletters #14, 18 and 23 the underwriting losses from the Mortgage/Financial Guaranty markets have been so huge so as to cause some confusion about the financial conditions in the general property casualty market. These being specialized markets, they didn't participate in writing any other forms of insurance coverage and have struggled to reinvent themselves in this recessionary period. Some are gone or merged while others seek ways to keep the infected or toxic credit business away from the historic core business...."good insurer-bad insurer" living under one roof! State insurance regulators appear to have missed the enhanced risks these insurers faced as their portfolio of business took on a very material change.



Charles L Ruoff CPCU

CR Market Strategies
crmarketstrategies.com

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.
