Insurance Executive Review

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

IS WALL STREET AT IT AGAIN? … DO WE NEED AN ENCORE SO SOON?

The financial market crises that led to the current recession are still fresh in everyone's mind…..or are it? We see evidence that the urgent need for new financial market regulations to avoid a repeat performance is waning as markets push back on any constraints to maximize profits and compensation. The environment of multiple financial institution failures or near failures have given way to a sense of having "stronger" institutions but are they now so big from assisted mergers that they present an even bigger risk? Have the huge mechanisms behind the manufacturing of those toxic assets been disabled or have they merely paused awaiting a return when the price (fee) is right?

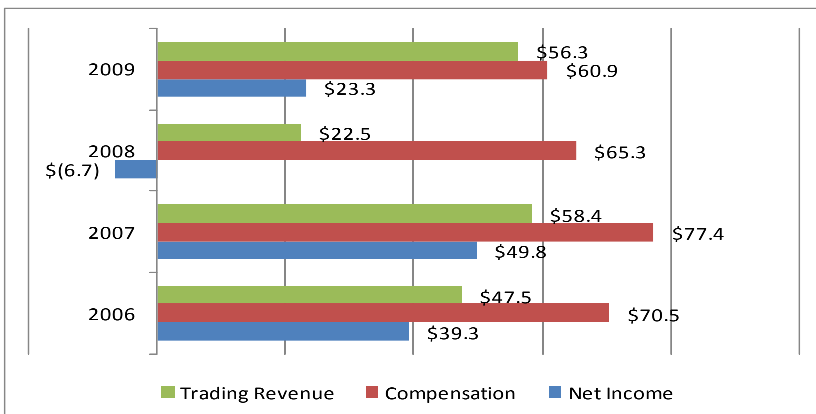
The insurance industry generally escaped the last financial storm with some notable exceptions. The Mortgage Guaranty and Financial Guaranty market (see Newsletter #--) were deeply involved in facilitating much of the toxic asset market acceptance. Some life insurers needed assistance with their investments supporting their underwater annuity products and other direct investments. A number of property casualty insurers took on more equity and hybrid investment risks that hurt their capital position short of being a fatal move. Finally, AIG once the behemoth of the insurance world suddenly was in need of lifesaving government assistance for taking on huge obligations in credit default instruments (non-insurance contracts) outside the reach of U.S. regulators.

So are we now so far removed from the storm that we might see a return to business as usual?

CHANGES IN REGULATION

There has been very little fundamental change in the way banks are regulated or in fact the way they run their operations today. We have fewer banking institutions with more than 100 failures as the Federal Government has pumped more than $200 Billion of equity into the remaining banks, offered guarantees and presided over mega mergers to save others with the total approaching $2.7 Trillion

TOP FIVE WALL STREET BANKS-6 MONTHS FINANCIAL DATA



But the top five Wall Street firms made $23.3 Billion in profits in the first 6 months of 2009 compared to $6.7 Billion in 2008 but well short of the $49.8 Billion in 2007. The lions share of the current profits come from trading profits or roughly $56 Billion in revenue meaning these firms are making huge trading bets. In regard to compensation that is down 10% we need to keep in mind that tens of thousands of jobs have

Source: Wall Street Journal (Bank of America, Citigroup, Goldman Sachs, J.P. Morgan and Morgan Stanley

been eliminated in the past 18 months so average costs are rising.

The average daily trading “value at risk” topped $1 Billion in the second quarter an 18% increase from a year ago but up about 75% from early in 2007 according to the Wall Street Journal. Federal officials that want banks to return to profitability appear to have encouraged banks to engage in vigorous trading. So new regulations appear to be less urgent now that bank profitability seems to be restored. The super large banking organizations that have been created now present an even bigger problem….taking even bigger risks with cheap borrowed funds and federal guarantees. This banking concentration has given the big banks a funding advantage of more than 30 basis points while three of the banks (Bank of America, J.P. Morgan and Wells Fargo) each control more than 10% of the nation’s deposits that was once a regulatory cap.

Bankers hope that Congress will continue to spend more time on healthcare issues and trade issues so it will divert attention away from any serious financial regulatory changes.

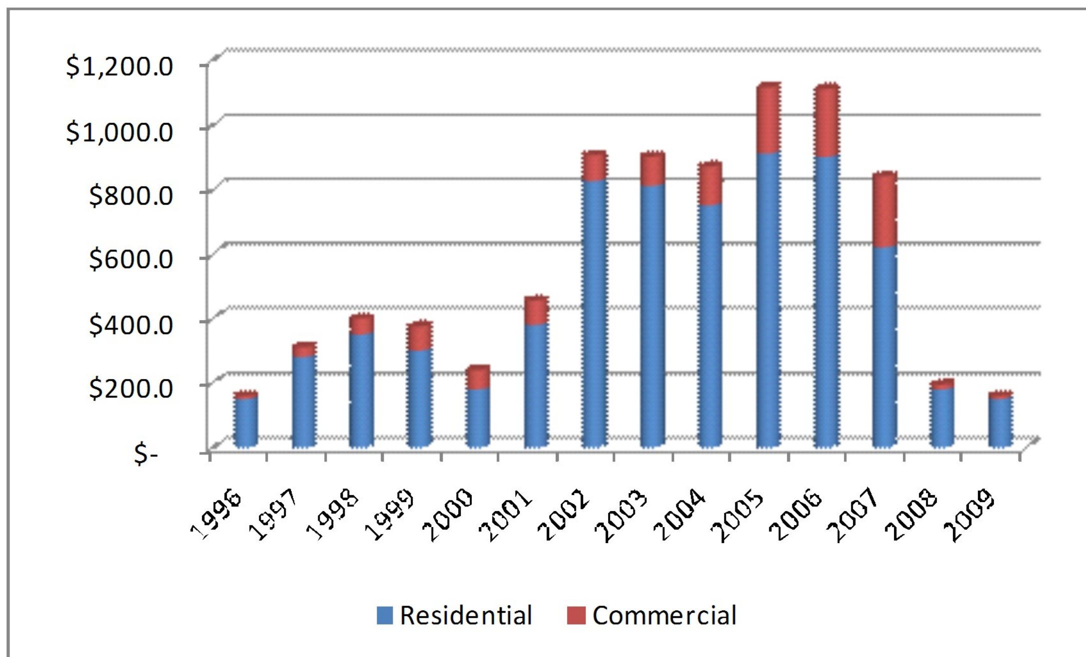
WALL STREET TIPTOEING BACK INTO THE POND?

It was reported that as of March 31 the notional value of credit derivatives outstanding in the U.S. banking system stood at $14.6 Trillion per the Office of the Controller of the Currency. That was down 8% since year end 2008 but nearly triple the $5.5 Trillion level back in 2006. There is a revived enthusiasm for exotic financial engineering including collateralized debt obligations (CDO) and some banks are putting their modeling geeks back to work designing a bundle of home and commercial mortgages into mini-CDOs.

U. S. Mortgage-Backed Securities (Billions of Dollars)

Source: The NY Times

While there is a huge mess of toxic assets overhanging the market that will take years to unravel. But as long as



there are investors willing take on higher risks for a greater reward there will be financial engineers in place at banking firms willing to deliver them for a generous fee. One new avenue of pursuit is the life insurance settlement market….what will they think of next!

The life insurance settlement market has been in existence for years essentially as a result of the low “cash sur-

render values" offered by traditional life insurance products. As policyholders age, their need for life insurance may change and the rise in premiums may make either cash surrender or forfeiture (lower limit of paid-up coverage) realistic options. But life settlement firms offer an alternative especially to the older sick policyholders by providing a much higher settlement offer (by thousands of dollars) to the policyholder in exchange for changing the ownership and beneficiary of the policy to the company. The latter pays the remaining premiums until the insured dies (sooner the better) then collects the face value of the policy. While this arrangement has been around for sometime it has been the subject of suggestions of abuse by prompting people to take out insurance for the expressed purpose of transferring ownership (some states require an in force period of 2-5 years). With a $26 Trillion of in-force life insurance policies and an ageing population it is an attractive opportunity some have suggested could reach $500 Billion. Some banks have already bought companies that originate life settlements while others are developing an "index of life settlements" so investors can take a direct position in this market or merely bet on the overall direction of that market.

SECURITIZATION OF LIFE INSURANCE SETTLEMENTS-GOOD FOR THE MARKET?

The securitization of life insurance settlements takes the practice to another level that is already suspect of arranging new life insurance sales for the expressed purpose of creating new settlement directed life insurance sales. It renews the concerns that being "beware of geeks bearing formulas" as predictions and over reliance based on assumptions and computer models are what got us to our current crises. Future changes in mortality tables based on specific health/illness medical breakthroughs and an emphasis on preventive care might easily change the expected future outcomes. This might be much the same way as regional values/credit levels of borrowers and not nationwide real estate declines were the basis of predictions built into the mortgage backed economic models. Just as bankers sought and obtained AAA rating agency support for their mortgage backed securities, there is an effort to deliver the same to these new securities but Moody's and S&P are not rushing to the fore…..but it seems other NRSRO agencies are prepared to deliver what is needed. There is already a limited market for these unrated life settlements but obtaining a rating from an NRSRO agency would materially enhance the market acceptance of these securities.

This comes just as the State Insurance Regulators have invited representatives of NRSRO firms on September 24 to attend a hearing on evaluating their reliance on rating agency credit ratings in evaluating insurers' securities holdings. Insurance companies hold nearly $3 trillion in rated bonds and in large measure relies on credit ratings to supervise capital asset requirements or reserves against those holdings.

So rating agencies in pursuing this new "life settlement" securities may not be endearing themselves to regulators who already find their methodology suspect as structured securities have been a huge problem.

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