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110 William Street, New York, NY 10038 ▪ 212.346.5500 ▪ www.iii.org

PROPERTY/CASUALTY INSURANCE AND SYSTEMIC RISK

Steven N. Weisbart, Ph.D., CLU – Chief Economist
Robert P. Hartwig, Ph.D., CPCU – President

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INTRODUCTION

To prevent another financial meltdown like the one that affected the world's financial system in the fall of 2008, regulators are now considering, as part of the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, criteria for determining which financial institutions might fail and, if they did fail, which would pose a broad threat to the financial system. Any institution thus categorized would be subject to closer scrutiny and more stringent regulation, making its failure less likely. Further, such institutions would be assessed fees for a fund that would help manage the obligations of failed institutions. This seems only prudent.

But the exercise can be harmful if it includes companies that pose no threat to the system. Property/casualty (P/C) insurers, not one of which failed as a consequence of the financial crisis or the ensuing "Great Recession," are one such category of company. Inappropriate inclusion of P/C insurers could cause harm not only to insurers, but to consumers and the efficacy of financial institution regulation in general. The potential harm could be of several kinds, certainly including the following:

- Higher operating costs for the insurer, both because of the extra fees imposed and the higher cost of increased regulatory monitoring and compliance, which would either reduce profitability or, if transmitted into higher prices, make the company less competitive in the marketplace;
- Lower returns on invested capital for the insurer, because of the additional capital systemically important firms will be required to hold, resulting in greater difficulty in raising capital;
- Reduced insurance capacity (i.e., supply) due to more stringent capital requirements imposed on firms deemed to be systemically important. The net impact is to reduce the supply of insurance available in the marketplace, reducing consumer choice and increasing price;
- Misallocated governmental resources, both in monitoring companies that pose no threat as well as possibly overlooking companies that pose a threat;
- Increased moral hazard. Fees assessed against companies that are not systemically important effectively subsidize and therefore encourage the undertaking of riskier activities by firms that truly do pose a systemic risk. The net effect is to increase the likelihood and possibly also the severity of systemically destabilizing events.

PROPERTY/CASUALTY INSURANCE AND SYSTEMIC RISK CRITERIA

By any reasonable or standard definition, property/casualty insurance operations pose no systemic threat to the financial system. Conceptually, there are six dimensions on which a financial institution might be deemed systemically important: size, uniqueness, leverage, liquidity, interconnectedness and the strictness of regulatory scrutiny. None of these alone makes a company a threat to the financial system. For example, a very large company that is not interconnected, has low leverage and has many competitors can fail with absolutely no systemic effect. Let's consider the property/casualty insurance industry in terms of these six dimensions.

1. Size and Uniqueness

There are some large property/casualty insurance companies, but the markets in which they compete are quite competitive. In the major insurance lines (auto, homeowners, workers compensation, general liability), no insurer has a market share over 25 percent (most have less than a 10 percent share), and there is an abundance of industry capacity in hundreds of companies to absorb the insurance business of even the largest P/C company. Moreover, all major property/casualty insurance markets are competitive, according to the standards applied by the U.S. Department of Justice. In addition, no property/casualty insurer provides truly unique products or services in any major market. Customers can (and do) change insurers to obtain better prices, service, coverage terms or for any number of other reasons.

2. Leverage

One of the great villains of the 2008-2009 crisis was excessive leverage: some financial institutions borrowed heavily to finance their activities, amplifying even small losses into massive impacts on themselves and their creditors. But the property/casualty insurance business model uses virtually no borrowed money (state regulators prefer it this way). Insurers pay claims mainly from premium revenues, supplemented by investment income and reinsurance and, when needed, from accumulated surplus (capital). Premium flows are affected by macroeconomic conditions, but not heavily; premiums have been (and are highly likely to continue to be) relatively steady from one year to the next.

Leverage, defined broadly as debt divided by net worth (capital), acts as an amplifier; the higher the ratio, the greater the likelihood of a small loss becoming a large one. At the peak of the crisis, some investment banks were levered at over 30:1. Under the property/casualty insurance business model, no insurer could ever be remotely close to that levered—nor would any regulator ever permit such a high degree of leverage. In fact, many P/C insurers have no debt at all on their books.

The primary source of funds for many other financial institutions is often borrowed money. Consequently, failure of these institutions implies that repayment of those borrowed funds is in jeopardy, triggering a ripple effect throughout the financial system and economy in general. Since property/casualty companies essentially do not

Steven N. Weisbart, Ph.D., CLU
stevenw@iii.org, 212.346.5540
Robert P. Hartwig, Ph.D., CPCU
bobh@iii.org, 212.346.5520

use borrowed money to fund ongoing operations or finance speculative investment strategies, in the rare instances when a failure does occur it is not transmitted to other financial institutions or to the overall economy.

3. Liquidity

Another of the villains in the crisis was liquidity, or rather the lack of it. Liquidity is the ability to convert assets into cash quickly and with virtually no cost or asset value decrease. A company that does not have enough liquidity might not be able to meet its obligations, causing problems for its creditors. A number of banks had that problem during the crisis, but no property/casualty insurance company did.

There are three reasons why P/C insurers did not suffer from liquidity issues during the financial crisis:

- First, maintaining a high degree of balance sheet liquidity is a basic tenet of the property/casualty business model and a significant focus of insurance regulation. Insurers generate significant and continuous cash flows through the collection of premiums, assuring access to liquid funds at all times and irrespective of investment market or economic conditions. Moreover, insurer investments are highly liquid. Nearly 70 percent of the P/C insurance industry's investment portfolio at year-end 2009 was held in high-quality corporate and government bonds with just under 20 percent in highly diversified stock holdings. Most of the remaining 10 percent was held as cash or very short-term securities.

- Second, property/casualty insurance claims arise not when policyholders choose, but when adverse events occur that are, by definition, random and out of policyholders' control. Thus, there is no danger of a large-scale and immediate demand for cash payments similar to a "run on the bank" for a P/C insurer.

- Third, when P/C claims arise they are frequently paid over the course of a few months or, for some lines of insurance, a few years. Again, the nature of P/C insurer liabilities does not lend itself to problems arising from liquidity challenges.

During the 2008-2009 crisis, only one insurance holding company had liquidity problems that were systemically significant. That company had two types of investment problems, neither of which involved property/casualty insurance operations. Both problems could have been prevented or minimized with appropriate investment regulation. One involved investments related to securities lending activity, which can be addressed most effectively with changes at the state insurance regulatory level. The other problem involved the sale of credit default swaps, which Congress decided were not insurance and so were not regulated as part of the insurance enterprise. This activity, too, can and should be regulated directly without the necessity of declaring a company systemically important.

4. Interconnectedness

A recent study for the National Association of Insurance Commissioners (NAIC), underscoring the lack of interconnectedness in the United States insurance systems, noted that:

> *In some parts of the world, insurance is linked directly to banking through cross-holdings of bank and insurance stock and/or insurer purchase of bank subordinated debt. Thus, theoretically, a spiral might develop…. [But] the risk of this occurring in the U.S. is minimal, as insurers do not hold a large enough amount of bank stock or bank debt to be able to influence their prices.* [1]

The same study also noted that:

> *A source of potential contagion/interconnectedness/correlation in the insurance industry that is frequently mentioned is reinsurance. …the fear is that the insolvency of several reinsurers would set off a cascade of losses among primary insurers.*

However, primary insurers generally diversify their reinsurance arrangements among several companies, and large primary insurers often sell reinsurance on other risks to the same companies from which they buy reinsurance, lessening their exposure to any reinsurance company on a "net" basis. Further, insurers that buy reinsurance always retain a portion of the risk they are reinsuring, never passing the entire risk on to another financial company. The NAIC study cited a G-30 study on this issue which concluded that "…there would be no systemic effect from [a hypothetical failure of reinsurers equal to 20 percent of the global reinsurance market]."

5. Strictness of Regulatory Scrutiny

Insurance is a tightly regulated industry. It is partly because of that system that, during the recent crisis, not a single insurer failed because of its P/C insurance operations—not one. This is, of course, in sharp contrast to the record of bank regulation. Hundreds of banks have failed since the beginning of the financial crisis and many more are likely to fail in the months ahead, according to the FDIC.

The stringent and conservative nature of state insurance regulation manifests itself in many ways. One principal regulatory tool for promoting the stability of the insurance sector involves the mandatory reporting of financial results using a distinct accounting system that is more conservative than the Generally Accepted Accounting Principles (GAAP) used by virtually all other industries. Known as Statutory Accounting Principles (SAP), insurance regulators effectively use accounting conventions to build in an additional buffer against adverse developments.

[1] Mary A. Weiss, "Systemic Risk and the U.S. Insurance Sector," Center for Insurance Policy & Research, National Association of Insurance Commissioners, February 23, 2010.

Steven N. Weisbart, Ph.D., CLU
stevenw@iii.org, 212.346.5540
Robert P. Hartwig, Ph.D., CPCU
bobh@iii.org, 212.346.5520

State insurance regulators also do not rely on rating agencies to determine the riskiness of insurer investments; they have their own investment-risk evaluation function in the NAIC's Securities Valuation Office. The errors and conflicts of interest associated with the ratings agencies are believed to be an important contributing factor in the recent financial crisis.

Coordination and cooperation between state regulatory authorities also fosters stability. For example, states work together through the NAIC to oversee nationally significant insurers, and those that "appear to be performing poorly are prioritized for detailed analysis by a group of experienced, seasoned financial regulators" (i.e., the Financial Analysis Working Group). [2]

Importantly, even in the rare case when a property/casualty insurer fails, the failure would not spread to cause difficulty for other insurers or the financial system generally. This is because state regulators, through a system of state guaranty funds, see that all legitimate policyholder claims are paid, first from assets of the failed insurer and, if needed, from assessments on healthy insurers. Over the last 20 years, such assessments on P/C insurers have averaged less than 0.2% per year. [3] The system is entirely self-funding. Never in history has a penny of federal or state money been used to bail out a property/casualty insurer.

CONCLUSION

Property/casualty insurance is fundamentally different from banking. It poses no systemic risk to the financial system. Its business model and day-to-day operations are not predicated on or financed by borrowed money. The industry is not highly concentrated—indeed, markets are highly competitive—and is strictly regulated through the use of conservative accounting rules enhanced by scrutiny of investment holdings. Even when insurers pass risk to other insurers, some of that risk is retained, and the amount shared is small and is diversified among several reinsurers. The industry also maintains a very high degree of liquidity both through the nature of its operations and its investment strategies. Strong cash flows, the inability of claimants to generate a "run" on insurer assets and a high quality and conservatively managed investment portfolio all contribute to the industry's proven stability. Taken together, it is clear that property/casualty insurance operations generate no systemic threat to the financial system.

[2] Ibid.
[3] Ibid.

SELECT REFERENCES

NOTE: The following publications provide a more detailed examination of these issues:

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Steven N. Weisbart, Ph.D., CLU
stevenw@iii.org, 212.346.5540
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bobh@iii.org, 212.346.5520