Society of Actuaries

Article from:

Risks & Rewards

March 2013 – Issue 61

WHY U.S. INSURERS FARED BETTER THAN BANKS: DID KEY DIFFERENCES GIVE INSURERS AN EDGE DURING THE FINANCIAL CRISIS?

By Max J. Rudolph and Rick Beard

This article first appeared in CFA Magazine, *May/June 2012, pp. 13 - 14. Reprinted with permission.*

Banks created headlines. Insurers muddled through. Concerns about systemic risk focused on banks during the 2008 financial crisis, but the insurance industry was relatively more stable. Some outliers generated sensational coverage (primarily AIG through its financial products division). Other insurers used the federal government Troubled Asset Relief Program (TARP), and publicly held insurers writing variable annuities saw their market value erode. In general, however, mass insolvencies among life, health, and property/casualty insurers were never a major concern. Surprise, surprise—could proactive and conservative regulatory and investment practices be good business practices?

To answer this question, the Society of Actuaries sponsored research intended to shed light on and learn from insurer practices. (The entire report can be found online at *soa.org/research/research-projects/finance-investment/research-us-insurance.aspx*)

INSURER BUSINESS MODEL

Insurers hold a majority of their assets in what are called general accounts. Separate accounts support liabilities such as defined-benefit plans or variable annuities, whereas the general account backs traditional insurance products, such as homeowner's insurance and whole life insurance. This article will focus on general-account investing practices.

Insurance covers a wide range of ongoing customer relationships, everything from a single payment to cover a specific loss to recurring premiums for the rest of an insured's life. Many of these payments are contractually required to continue the protection provided by the policy. Health and many property/casualty products operate as a revolving door driven by the law of large numbers, spreading risk over many policyholders while keeping most assets in short- and intermediate-term (i.e., liquid) investments so claims can be paid quickly. Operating earnings provided regular cash flow even during the crisis. If incoming and outgoing cash flows are considered separately, premiums can be thought of as an asset that improves liquidity. Many products provide a savings element and cash values. Incentives encourage policy persistency, allowing insurers to invest in longer-term assets. The insurance industry did not experience a run-on-the-bank scenario during the crisis.

INSURER REGULATORY FRONT

In the United States, insurers are regulated by state governments. Any state in which a company does business can provide oversight, but the primary regulator is the state of domicile or home state. A company's regulatory capital requirement is reduced if its asset and liability cash flows are well matched, which generally means bonds dominate asset allocations. Capital requirements discourage, or minimize, volatile asset classes, such as equities and alternative investments. This makes insurance companies less susceptible to the ups and downs of the financial market. Reporting inconsistencies in many states (mainly minor) increase costs to the financial reporting process and frustrate managers, but the possibility of multiple states providing oversight in slightly different ways has advantages as well. Concentration risk comes in many forms.

Current international proposals seem intent on consistent standards. Regulations always deal better with past issues than future ones, and multiple sets of eyes looking at a company in slightly different ways are more likely to catch an emerging issue than a single regulator blinded by bureaucratic consistency.

AIG AND REGULATORY ARBITRAGE

When an insurer is set up as a holding company (as AIG is), the states regulate its insurance subsidiaries but the company can select its overall regulator. As the Financial Crisis Inquiry Commission has explained, AIG chose a federal regulator (the Office of Thrift Supervision, or OTS) that was incapable of handling the complexity of the credit default swap products that AIG's financial products division sold. In a clear case of models trumping common sense, gross exposures were ignored because default probabilities were assumed to be miniscule. Outside input, especially when skeptical, was not welcomed.

INVESTMENT PRACTICES

The Society of Actuaries' survey found that adherence to conservative investment policy statements (IPSs) was a principal contributor to the insurance industry's portfolios surviving the downturn. Almost all had a formal, board approved IPS that they consulted and followed during the crisis. Implementing a proactive, living document enabled many insurers to hit the ground running when looking for bargains during the 2008–09 period. The IPS provided stability and much-needed guidance when working with board members who are not investment experts.

Internal (or outsourced) credit risk expertise helped minimize the insurance industry's exposure to the worst effects of the housing bubble. Very few insurers had material subprime mortgage exposure by 2008, and many had sold the asset class completely before the crisis.

Insurance industry regulation is built around solvency protection for policyholders. Transparency and conservative investment policies are key components. Regulatory requirements force insurers to report each asset held at the end of a calendar year as well as purchases and sales. These reports are publicly available. Both capital requirements and regulatory concentration limits encourage conservative investment practices. This combination discourages the high flyers (those seeking to leverage capital and concentrate assets) from entering the domestic insurance industry. Other avenues provide easier access to funds for aggressive investors.

LESSONS LEARNED

So what lessons can be learned from this research to help insurers prepare for the next crisis? Some insurers struggled through the financial crisis, but those focused on general account products were in a better position to succeed. Through the survey and discussions with industry participants, we reached a number of conclusions:

- Liquidity can go away very quickly, especially when everyone is counting on the same tools for risk mitigation. This kind of systemic concentration risk is ongoing. Investors who proactively develop multiple sources of liquidity will be rewarded during a downturn.
- Insurers should actively manage liquidity, credit, and interest rate risks using specific stress scenarios and have the results reviewed with independent oversight.
- State guaranty funds should assess risk charges that are based on risk exposures. This practice aligns incentives and reduces moral hazard.
- Insurers have advantages related to cash flows during a crisis relative to other financial services firms—that is, they often have long-term contractual relationships with customers.
- Regulatory investment constraints are conservative relative to other financial institutions, which tends to drive the most entrepreneurial investors elsewhere. This provides a safety net that makes it harder for insurance company investment professionals to threaten company solvency through their investments.
- Insurer filings require transparent reporting of all securities held. This requirement is more stringent than the disclosure demanded for other types of financial institutions and encourages insurers to stay with standard asset classes. It also seems to drive aggressive entrepreneurial personalities away from the industry.

CONTINUED ON **PAGE 22**

"…. INSURERS ARE NOT KNOWN FOR THEIR QUICK REACTIONS TO MARKET CHANGES, BUT THE INVESTMENT PROCESS THEY HAD IN PLACE PROVIDED CONSERVATIVE CONSISTENCY."

- Financial leverage (borrowing) limits flexibility during a crisis. The market can stay irrational longer than a company relying on leverage can stay solvent. Insurers use low amounts of true borrowing, although their basic business model uses float (i.e., cash is collected today with promises to pay it back to policyholders at a later time).

- An IPS should evolve over time to reflect asset classes and liquidity tools available for use during both normal and crisis scenarios.

Overall, insurers did seem to perform better than banks during the recent crisis. A general business model that incorporates recurring premiums (along with regulatory conservatism and internal credit analysis) led to these results. Insurers are not known for their quick reactions to market changes, but the investment process they had in place provided conservative consistency. The IPS was the key to this success for insurers of all sizes and types. It provides a consistent process and plan that an investment team can use to stay within conservative bounds in the event of future bubbles or during an actual crisis—because such possibilities have been considered proactively and contingency plans have been prepared in advance.

Max Rudolph, FSA, CERA, CFA, MAAA, is founder of Rudolph Financial Consulting, LLC, in Omaha, Nebraska, and a member of CFA Nebraska. He can be contacted at max.rudolph@rudolph-financial .com.

Rick Beard, CFA, CIPM, is managing director of Cardinal Investment Advisors and a member of the CFA Society of St. Louis. He can be contacted at rbeard@cia-llc.com.