I Want You to Feel Your Pain!

by Dr. Krzysztof Ostaszewski

As time passes from the gripping moments of panic in the financial markets in the fall of 2008, the question of the legacy of the crisis remains with us. The Panic of 2008 has wrought the Great Recession, the first economic crisis since the 1930s in which the United States has experienced two years in a row with unemployment of near 10 percent or more. For some, this is a convincing evidence of excesses of unhampered greed. For others, the events that unfolded provided convincing evidence of pursuit of unlimited power. But the institutional legacy of the crisis appears rather clear: Greatly increased role of the Federal Government of the United States, and the Federal Reserve System, in the economic and financial systems of the United States and the world. In those gripping moments of panic, these two institutions acted mainly in one capacity: As insurers of last resort for systemic risks undertaken by economic and financial decision makers. True, one could view what happened as *retroactive reinsurance,* but regardless of terminology, the actions undertaken are now a part of the path leading to the future, permanently.

Insurance is, as I see it, the most fascinating of all business activities. I hold this view, because I firmly believe that both the public image and the self-image of the insurance industry are at odds with its economic nature. In order to explain my claim, allow me to pose this question: What is the contribution that the insurance industry makes to the economy and to the society? According to the unfortunate public image, there is no contribution: after all, property/casualty companies pay back to their customers about 65 cents for every dollar received in premium, and health insurance companies pay back about 80 cents for each dollar in premium. I always defend those actions to prospective actuarial students by explaining that those poor companies have no choice, they need the money to pay exorbitant salaries of actuaries, but that argument does not always work with the general public.

On the other hand, according to, equally unfortunate, self-image of the industry, the contribution is *protection*. We are paid for providing security, peace of mind, financial well-being, to our customers. When combined with increasingly common compulsion of insurance purchase, this does not create the best of images either.

I humbly submit that both of these propositions are false. The insurance industry, at least of non-compulsory type, would not exist if as a result of its activities the wealth of the entire society did not expand. True, an individual insurance transaction does not create wealth, it merely redistributes the cost of loss, while moving the major portion of the risk from the insureds to the insurer. The funds paid for expenses and profits of the insurer are a net loss to the insureds. How can any value created then? In order to see the source of the value created we should ask ourselves: Why did this transaction happen in the first place? This is very similar to asking the question: Why is ice cream with half the fat and half the calories produced? Obviously, the answer is: So that we can eat twice as much ice cream.

By shifting the risk from the insureds to the insurer, we affect the behavior of the insureds. Once the consequences of the risk are absorbed by someone else, the insureds can assume more risk. For some strange reason, the industry calls this process a *moral hazard*. It is, of course, most of the time, a *moral security*. Having the protection of an insurance contract, the insureds can undertake more economic projects. They can build more factories, or more parks, or more homes. They can plan new enterprises in Utah, in Botswana, in Indonesia, or, one day, on Mars.

In other words, our industry's mission, our contribution to the society, is to get people to do more crazy (well, at least risky) things. We should call this *moral security*, as opposed to the derogatory term: *moral hazard*.

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So why is the industry so concerned with the issue of moral hazard? Actually, by doing so, the insurance industry is expressing a deeper understanding of the nature of its business. An insurance transaction produces three effects:

- A portion of the risks faced by the insured, as specified in the contract, are absorbed by the insurer,
- A portion of the financial resources of the insured are paid to the insurance company, and
- As the result of the transaction, aggregate risks undertaken in the society increase.

The third result is commonly called moral hazard, but if the risks undertaken result in more economic output, greater happiness, greater wealth, etc., the society benefits. The best possible scenario is the situation where wealth created by the new crazy activities undertaken is greater than the expenses and profits of the insurer. And the worst possible scenario is when additional risks created by the insurance contract reduce the overall wealth of the society. An insurance firm entering into a contract has limited information as to whether provision of insurance will result in moral hazard, or moral security. It also has limited tools at its disposal to address that dilemma. Those tools are: the structure of the contract and the pricing of it. The key issue is that the insureds creating moral security should be rewarded, and those creating moral hazard should be punished. As in all areas of economy, the solution is expressed in an immortal quote from a great work of American Art, the 1985 film masterpiece: *Back to the Future*. After his unexpected time travel from 1985 to 1955, the hero of the masterpiece, Marty McFly enters a 1950s diner and is promptly instructed by its proprietor that if he wants to remain at the premises, he should order something. So he orders a 1980s novelty: Pepsi-Free. The proprietor responds: "You want Pepsi buddy, you gotta have to pay for it!"

But what if the economic decision makers want their Pepsi-Free, or rather a new financial product that might be called *Risk-Free*, but do not want to pay for it? The private insurance industry will not willingly enter into such foolhardy transactions, thus protecting the entire society from moral hazard calamity. But the economic agents that desire *Risk-Free* can capture the government and have the funds needed for their purpose created out of nothing by the central bank.

The legacy of the Panic of 2008, and the legacy of all bailouts of institutions that have been deemed *too big to fail*, is that the United States Federal Government and the Federal Reserve System, have permanently become providers of the *Risk-Free* product, below cost, or at no cost, and under direction of political forces.

And let us not forget that every insurance transaction, whether formally recognized as insurance, or informally created as a bailout, increases overall risk. Additionally, the portion of risk absorbed by the provider of insurance, is always in excess of that remaining with the insureds.

Thus, the lasting legacy of the crisis is the situation where the United States Federal Government and the Federal Reserve System are repeatedly increasing systemic risks, and simultaneously assuming responsibility for increasingly larger share of them. And let us remember that, unlike for Goldman Sachs or Citibank, there is no backstop for the United States Federal Government or the Federal Reserve System. Nobody will bail them out. Let us ponder for a moment what a failure of these institutions would mean.

But, luckily, there is a magic bullet. Realizing that the United States Federal Government and the Federal Reserve System cannot find a reinsurer for their insurance business, I Want You to Feel Your Pain! *by Dr. Krzysztof Ostaszewski*

and cannot properly price existing business, we should simply acknowledge that no new insurance business should be written by them, and the existing business should be unwound, or run-off at the lowest possible cost.

To those still using their political power to seek cheap or free protection, the Feds must simply say: *I Want You to Feel Your Pain!*

Of course, given the recent excesses of rampant and omnipresent grabbing of resources of the United States Federal Government and the Federal Reserve System by anyone with powerful enough political connection, one might wonder if this is possible.

But let us not fool ourselves that the current *Risk-Free* joy ride can continue. The magic bullet resolution is bound to happen, one way or another, maybe gradually, maybe with a bang, or maybe with a whimper.

There will come a time when Uncle Sam will say: *I Want You to Feel Your Pain!*

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