WE ARE NOT IN KANSAS ANYMORE

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The famous 1939 movie, The Wizard of Oz, is set in the USA state of Kansas. Life in Kansas is predictable and pleasant, if a bit dull. When a tornado rips through the farm where young Dorothy lives, it hurdles her home into the sky along with Dorothy and her little dog, Toto. The house comes crashing down in a strange land. Dorothy grabs her dog and crawls out of the destroyed house. She looks around and says those immortal lines "Toto, I've a feeling that we're not in Kansas anymore".

Like Dorothy, we are no longer in the predictable, pleasant and certainly not dull financial equivalent of Kansas. We are in a strange, new financial land. Let us explore some of the effects that this financial tornado holds for the insurance sector, including some lessons to be learned from the crisis.

Setting the Economic Scene

To explore these lessons, it is important that that we first set the economic scene. As we all know, the world has been experiencing the worst economic downturn since the Great Depression of the 1930s. Fear and panic spread throughout the world's financial systems and economies. Governments and central banks embarked on massive efforts to shore up their financial institutions and economies.

The crisis had its origins in a credit boom which combined with and reinforced a housing bubble in the US economy. The US housing bubble burst in early 2006. The two defining events were the March 2008 rescue by the government of Bear Stearns, the fifth largest US investment bank, then considered as being "too big to fail" (TBTF), and the stunning bankruptcy of Lehman Brothers, the fourth largest US investment bank, in September 2008, which the government wrongly considered as not being TBTF. Its failure caused the interbank markets to seize, as banks did not trust each other's solvency. Runs commenced on money market mutual funds because the benchmark of one dollar per share was breached by one of the largest US money market funds. This money market fund share price "broke the buck" because it was invested heavily in Lehman. At the same time, collateral calls flooded AIG's

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financial products division on some $500 billion worth of its outstanding credit default swaps. AIG would have collapsed except for the government bailout.

The global financial system was on the verge of collapse with negative systemic effects rippling throughout the real economy. Economists and policymakers realized that this was no ordinary recession. It was unlike any recession that most had ever witnessed, and uncertainty as to how best to deal with it was much in evidence. Several developing economies, including particularly China and India, were not hit as hard because they had high domestic demand; large, diversified economies; comparatively severe investment restrictions on their financial institutions; high domestic savings rates; and effective monetary responses by their governments.

What caused this "Great Rescission", as it has been labeled? We can separate the myriad causes into three categories. In order of importance, they are

(1) government failures,
(2) market failures, and
(3) global financial imbalances.

The analysis in this article is necessarily brief and incomplete, but may be sufficient to offer a reasonable overview. First, as to failures by government: many economists believe that this crisis would have been just another recession but for certain actions and failures to act by the US government and two of its government-sponsored enterprises (GSEs) involved in promoting home ownership.[1] Thus, lax interest rate policy by the US central bank, plus other actions, contributed toward a doubling of housing prices from 2000 to 2006, feeding the housing bubble and credit boom. Also, aggressive buying by the two GSEs of sub-prime loans from banks, signaled banks to make even more such loans, which they did - creating a self-reinforcing, downward spiral. The two GSEs collapsed, requiring massive government support, as they were considered TBTF -- exactly as the market had anticipated, with all of the moral hazard implications. Additionally, the US government has a long practice of providing generous subsidies to promote home ownership, especially in the form of a deduction from taxable income for interest paid on home mortgage loans, thereby artificially stimulating both housing and credit demand for decades.

Besides taking poorly conceived actions, government also failed to take some needed actions. For example, prudential regulation of commercial banks was ineffective for various reasons, including problems in measuring bank risk (because of reliance on credit rating agencies' assessments and internal bank risk models) and the TBTF problem rendering effective discipline of large, complex financial institutions (LCFI) difficult.

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[1] These are the Federal National Mortgage Association -- called Fannie Mae -- and the Federal Home Loan Mortgage Corporation -- called Freddie Mac. Together they accounted for about 1/5 of all US mortgage securities or about $1.4 trillion.

Additionally, bank regulators apparently took no action to stem the increasing practices by banks of lowering underwriting standards for loans, fostered, of course, by the knowledge that they could remove the risky loans from their balance sheets by having the two GSEs purchase them and by packaging the loans (securitization) for sale in the market.[2] Nor did they take action to stem regulatory arbitrage by banks when banks securitized their loan portfolios, then turned around and invested in various collateralized debt obligations (CDOs) thereby putting them back on the balance sheet -- and in the process incurring a lower capital charge.[3] Banks were also encouraging and supporting off-balance-sheet special investment vehicles (SIVs) that also bought such securities. All of these SIVs failed, with the result that banks were required to bring the liabilities back to their balance sheets because of side agreements. Where were the regulators?

Further, a 2004 policy change by the US Securities Exchange Commission (SEC) resulted in investment banks effectively being allowed to take on excessive leverage; as much as 40 to 1.

Finally, the government failed to develop and implement a system that requires systemically important financial institutions to be assessed, not solely on their own risk, but also on the risks that they impose on the system as a whole. In other words, government guarantees for TBTF were not priced correctly; indeed, they were not priced at all.

But financial institutions also have much to account for. The crisis was abetted by market failures. Specifically, there was excessive faith and reliance on rating agencies' (unrealistic) ratings of CDOs and other derivatives. Also, within the US housing markets, there was a long-held belief that house prices simply did not fall; they may remain flat for some time, but they did not decline. Financial institutions developed risky mortgage products and lowered underwriting standards based on this flawed perception, such that the crash in housing values resulted in throngs of mortgage loans being "under water" and customers being unable to meet rising loan payments.

Private sector financial institutions clearly accorded insufficient attention to enterprise risk management (ERM), including an unwarranted faith in the absolute validity of their own financial models. This failure attaches less to the models themselves and more to those who failed to appreciate that the models' results were only as good as the assumptions and data on which they were based. Another major ERM failure attaches to these firms' boards of directors that seem to have been poorly informed about firm risk or perhaps just overwhelmed by the complexities of trying to understand the risks inherent in LCFIs. Boards also agreed to flawed

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[2]Moreover, the rating agencies -- as is well known -- grossly overrated the credit quality of these securities.

[3]The capital charge for mortgage loans was 4 percent. The capital charge for AAA rated mortgage backed securities was 1.33 percent.

executive incentive arrangements that encouraged and rewarded short-term profit maximization (within businesses that focused on the long-term) and that failed to take account of attendant risks.

Finally, global imbalances caused by massive current account surpluses in China and major oil exporting countries, plus a low US savings rate, are said to have contributed to the glut of funds available for all sorts of loans in the US and in several other countries, including for housing.

Effects of the Crisis on the Insurance Sector

What have been the effects of the crisis in the insurance sector? Of course, investment portfolios of insurers in most countries lost substantial value. To date, the world's insurance industry is weakened but still fundamentally sound. Thus, unlike the banking sector, I am unaware of any major counterparty issues as between insurers, reinsurers, and retrocessionaires; any major liquidity issues in the insurance sector; or the failure of any large insurance groups and only a few smaller company failures, except AIG and a couple of European LCFI which were special cases not involving traditional insurance.

Worldwide, commercial banks have received the great majority of government-provided support. Very few insurers and no reinsurers of which I am aware have requested support. For example, for the US, while more than 600 commercial banks have requested and received bailout funds; only two insurer groups have - not counting AIG.[4]

As to other-than-investment effects of the crisis on the insurance sector, we have observed the following with regard to the life sector:

** Major declines in writings of individual life insurance in general and variable (unit linked) in particular (e.g., -25 percent in US);
** Insurers selling unhedged variable (unit linked) annuities, fixed annuities, and par business with various types of guarantees have been hit hard as the guarantees began to "bite";
** Substantial repricing and product redesigns;
** To date, there has been no major impact on mortality or persistency experience in most markets, but the latter could change;
** Considerable decrease in fee income from separate account business; and
** Increases in Merger & Acquisition activity.

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[4]Nine largest US banks received $25 B each in October 2008. Citigroup has received $50 B and Bank of America $45B to date.

With regard to the nonlife sector, we have observed the following:

- ** Unlike other post-WWII recessions, profound influences on both insurance supply and demand;
- ** Decreases in surplus affecting prices, providing upward pressure but this is offset to a greater or lesser degree by insureds purchasing lower limits and higher retentions and with the inevitable slowdown in new business because of fewer home and automobile sales;
- ** Increasing fraud; and
- ** Marked increases in lawsuits, particularly regarding directors and officers.

Lessons from the Crisis

What are some of the lessons to be gleaned from the crisis? For insurance companies, the crisis has reinforced the strategic imperative for sound corporate governance in general and ERM in particular. The central role and importance of the chief risk officer is evident, as is a corresponding need to ensure that ERM lies at the core of all activities, including having the Board devote greater time and effort to it. Insurers ought to ensure that executive incentive programs are aligned with enhancing total firm value over the long term, not just shareholders' equity, and that they reflect risk.

Life insurers have learned that guarantees built into various products really are options and, as such, have value that should have been priced into the product cost.

Nonlife insurers have learned a parallel lesson that underwriting profits are crucial to long-term prosperity. All insurers have learned the importance of having independent directors who understand finance and who are willing and able to challenge the board chairman and senior executives.

The crisis also offers lessons to insurance regulators. First, it is critical that we not lose sight of the fact that the crisis arose and remains primarily a banking sector issue. Regulatory remedies that are rational for banking are not necessarily rational for insurance. Insurers are different from banks.[5] Therefore, insurance regulators' positions might start from the admonition given to physicians, "first, do no harm".

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[5]Insurers should be treated the same as banks when they use the same instruments. But they have different operating models and this should be recognized. Insurers have comparatively low leverage; do not rely on the capital market for working capital; generally pose little or no systemic risk, including not being subject to runs for the most part; have no "originate-to-distribute" model; engage in comparatively little securitization and where done with insurance-linked instruments, such as cat bonds, it has been for risk management purposes, with insurers retaining much of the exposure.

Moreover, we should recognize that, while many important market failures contributed to the crisis, its severity seems to be attributable primarily to government failures, not failures of the market and certainly not failures in the traditional insurance market. Indeed, many have argued that, except for insurers within LCFIs, regulatory issues in insurance have more to do with effective implementation of existing laws and regulations than a need for a raft of new ones.

The crisis has also highlighted the need for greater transparency. For example, I hope that other insurance regulators do not succumb to political pressure to relax accounting standards for insurers as was done in the EU and US. While on this subject, the crisis has also highlighted the desirability of a single financial reporting standard, not separate standards by constituency (e.g., differing standards for regulatory and market purposes). Also, the crisis has plainly confirmed the need for more effective oversight of LCFIs.

As for capital standards, which have long been recognized as critical, regulators might be wise to consider some variation of the EU's Solvency II approach as a new path toward more effective solvency oversight. Related to this would be the various new initiatives of the International Association of Insurance Supervisors, especially related to overall market stability issues. Having said this, we should recognize that insurers are not generally considered systemically important in the sense of being considered TBTF.[6]

Conclusion

National and internationally oriented insurers and reinsurers have largely continued to operate in an orderly manner with comparatively little government intervention needed. They have similarly continued largely to service their customers well with no major impact on insurance supply. Even where required, government actions have been taken regarding insurance within a context of LCFIs wherein the traditional insurance operations were not the motive cause of financial difficulties.

It would be wrong to blame competitive markets, as such, for the crisis. We know of no system of societal resource allocation that is superior to appropriately regulated competitive markets. And we have known since at least the 1930s that competitive markets inevitably have imperfections that government must address, as Keynes (1936) emphasized. Government's failure to do so is an indictment of government, not of the market. Thus, insurance regulators should avoid the easy temptation to revert to insular, restrictive, or collusive markets.

[6]This statement does not necessarily apply to LCFI containing insurance companies. With such LCFI, however, the systemic risk flows not from insurers per se but from the very nature of the large, complex institution.