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The Credit Crisis and the Insurance Industry
10 Frequently Asked Questions

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1. Have insurers contributed to the subprime and subsequent financial crisis?
There are no indications whatsoever that insurers have contributed to the systemic issues that many banks are facing today. Insurers have not originated and repackaged subprime mortgages. They did not act as major investors in mortgage-based financial instruments. To the contrary, the insurance industry displayed resilience in the face of adverse market conditions and was in a position to absorb market volatility as an institutional investor with a long-term perspective. In this sense, the insurance sector acted as a stabilizing factor at a time of considerable stress in the global financial system.

2. How were insurance companies impacted by the crisis?

As far as the global insurance industry is concerned three different kinds of impact need to be carefully distinguished: First, the direct impact of first-round effects related to credit losses on subprime mortgages; second, the impact on those financial institutions with specific exposures such as CDSs, banking operations and financial guarantee business and, third, the general impact of the asset meltdown which accelerated dramatically in September 2008.

Despite the fate suffered by AIG, most insurers escaped largely unscathed from the first-round effects of the subprime crisis. This is no small achievement as insurers are major players in the financial markets. In 2006, the insurance industry had USD 18.5 trillion of assets under management, or 11% of global financial assets. This placed insurers only slightly behind pension funds (USD 21.6 trillion) and mutual funds (USD 19.3 trillion).

The direct impact of the crisis on insurance was limited, not least due to the wide diversification in insurer's investment portfolios. Insurance economists expect investment write-downs directly related to subprime mortgage instruments not to exceed USD 80 billion. This corresponds to around 3.5% of the global (re)insurance industry's capital or a mere 0.5% of invested assets. The banks, according to the IMF, have suffered considerably higher credit losses (an estimated USD 600 billion).

On the product side, insurers are being exposed as providers of Directors and Officers (D&O) as well as Errors and Omissions (E&O) policies. Most recent estimates put expected claims at less than USD 10 billion.

A second kind of impact has been observed at financial institutions where the core insurance business was complemented through other financial services activities. Most prominently at AIG and Fortis, significant losses occurred on financial products (mainly CDSs and other financial guarantees) and banking activities. Their insurance operations, however, have repeatedly been reported as sound by the supervisory authorities whose stringent controls of insurance activities had a positive effect.

The third form of impact, i.e. realized and unrealized investment losses, are impossible to gauge at the time of writing this article. There is no doubt, however, that the insurance industry as one of the world's biggest asset managers will suffer from falling stock market valuations and dramatically widening bond spreads. The sector, however, is relatively less at risk from the retrenchment of stocks than during the previous stock market crisis of 2001-03, as many insurers reduced their equity ratios in recent years. Losses on government bonds and commercial fixed-income securities will however affect the portfolios directly. This is especially relevant to life insurers.

3. Why were insurance companies generally less affected than banks?

One reason is that insurers, based on their fundamental business model, are not affected in the same way by liquidity risks as other financial institutions – at least as long as they abstain from conducting that sort of financial business that resulted in such dire problems elsewhere. They are prefunded by a relatively stable flow of premiums. They generally do not rely on short-term market funding and, therefore, are not subjected to the kind of liquidity risk affecting banks. A second reason is that, following the equity market downturn earlier this decade, the insurance industry has rediscovered the crucial role of asset-liability management and the necessity to maintain a strong focus on well diversified investment portfolios.

4. Why did insurance companies ask for public capital injections and lending facilities?

Only a very small number of insurers have had to ask for public support. They have been doing so chiefly because of their particular exposure to financial products and banking activities, i.e. for reasons unrelated to their core insurance business. The companies in question account for less than 3% of global non-life and life premium volume.

5. What is the near-term outlook for the industry?

Given the unprecedented volatility of market conditions it is impossible to provide meaningful forecasts. Assuming continued financial market turbulences, in combination with a potentially protracted slowdown in global economic activity, further substantial declines in asset values cannot be ruled out. Up to now, even the current drastic deterioration in the financial markets has generally fallen within the range of standard stress scenarios performed by most leading insurance companies. Despite this resilience there is a threshold – even if at valuation levels considerably lower than today's – where profit concerns develop into real solvency issues.

On the liabilities side, claims tend to increase in times of a weakening real economy. This adverse effect, however, should be mitigated by receding inflationary pressures due to an expected global recession and declining commodity prices.

In this environment, insurers and reinsurers are expected to maintain strict underwriting discipline and a cautious, ALM-driven investment profile in order to preserve their capital base. Hardening rates, especially in commercial lines, should help companies navigate through the credit crisis-induced turmoil.

6. Post-crisis, how will the insurance industry's business model look like?

First of all, the credit crisis has not questioned the basic business model of the industry, i.e. insurance risk underwriting. There is no shortage of cover for life or non-life insurance. Capacity appears to be abundant even though prices have started to harden in certain business lines. Banks, on the contrary, have curtailed lending and are reviewing their securitization and originate-to-distribute business models. Investment banking is changing with traditional Wall Street firms disappearing or being morphed into universal banks.

In general, the financial crisis is expected to encourage insurers to remain strictly focused on their core business of risk underwriting.

7. Should insurers be more rigorously regulated?

As far as core insurance activities are concerned, regulation has proven adequate and effective. Nonetheless, in light of the current unprecedented level of regulatory activity in financial services, the insurance industry faces the danger of collateral damage if regulation is based on the inaccurate assumption that banks and insurers are offering similar services and pose similar threats to financial stability. As a matter of fact, the nature of the services provided, the underlying business models and the risks associated with them, differ considerably. This must be reflected in different regulation and capital requirements for both industries - also in the future.

The companies that have suffered most in the insurance space as a consequence of the credit crisis are chiefly those that combined insurance and banking operations. This is where regulators and supervisors will be alert in the future: insurance companies branching out into risky ventures (such as banking or financial guarantee business) or other riskier players (such as banks or financial guarantors) moving into insurance, creating possible transmission mechanisms previously unnoticed.

It is of particular importance that the new Solvency II framework is implemented without delay. It will introduce a holistic view for all business, investment and operational risks of an insurance company, and it places a strong focus on the quality of internal risk management. From an economic point of view, Solvency II offers the best possible regulatory framework to diligently implement the lessons learned from the crisis and to ensure the sector’s long-term viability.

8. Which lessons can the industry draw from the financial crisis?

This question is difficult to answer in general terms, as the companies have been affected to widely varying degrees. However, most insurers will probably conclude that their corporate strategies should remain firmly focused on core competencies in risk underwriting and avoid unfamiliar areas such as complex financial products.

Insurers will also be encouraged to pursue or continue with conservative investment strategies which also take into account hitherto underestimated liquidity risks, i.e. the possibility of markets drying up and any meaningful valuation becoming impossible.

The industry will also have to underline more openly the special role it plays in financial markets and for modern economies as stable and long-term oriented operators. The crisis has shown how underdeveloped in many quarters a solid understanding is of what the insurance industry does and how it operates.

9. How can insurers restore policyholders’ trust?

So far, no insurance company has defaulted on its obligations vis-à-vis policyholders. However, there is a general sense of uncertainty as the financial services industry is under enormous public pressure and scrutiny and a small number of large insurance companies have experienced significant calamities.
In this environment, open, transparent and honest communication is a necessary condition for restoring trust. Such efforts, however, need to be accompanied by superior performance meeting customers’ expectations: Transparent and competitive rates, flexible terms and conditions, timely claims payments, continuous product innovation, to name the most important performance elements.

10. How can insurers contribute to a rapid end the financial crisis and economic downturn?

The most effective contribution is to continue to perform the industry’s key role in a modern economy: (1) promote financial stability and security at both the national and personal levels, (2) encourage productive investments and innovation through the mitigation of the consequences of financial misfortune, (3) mobilize savings and (4) contribute to an efficient use of capital of capital based on insurers’ role as significant institutional investors.