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The Federal Reserve's recent announcement that it will purchase \$600 billion of Treasury debt over eight months in an effort to lower long-term interest rates could have significant implications for the property/casualty insurance industry. Due to the nature of their business, most P/C insurers have a conservative capital structure with a low level of long-term debt compared to shareholder's equity.

In a growing economy, this conservative capital structure serves the industry well because most insurers generate a positive operational net cash flow due to the nature of their business (which involves collecting premiums prior to paying claims).

Under normal market conditions, insurers rarely rely on long-term debt to fund operations, and the excess operating cash helps fund their investments and financing. But given the stagnant economy and the Fed's recent action, will some P/C insurers take advantage of lower interest rates to increase their debt level relative to shareholder's equity? While it is unlikely that most insurers will significantly alter their capital structure, there are several reasons why a select few may increase their level of debt issuance.

The first is financial leverage. Increasing the ratio of debt to equity by issuing low-cost debt and buying back stock increases an insurer's return on equity (assuming the marketplace and regulators view the insurer as being financially and operationally strong enough to meet its fixed payment obligations over the long term).

The next reason they might is to improve their efficient use of capital. While the ultimate effect of the recently passed Dodd-Frank Act, with regard to the allocation of capital, is uncertain, Solvency II in the European Union, which goes into effect in 2012, emphasizes the efficient allocation of capital. These regulatory reforms may increase the insurance industry's need for, and cost of, capital. Having access to long-term, low-cost capital in the form of debt will help insurers deliver competitive returns to shareholders.

Mergers and acquisitions could be another motivator. The soft phase of the insurance profit cycle will not last forever. The hard market phase of the cycle is historically characterized by increased rates and profitability. By borrowing low-cost, long-term funds and using the proceeds to acquire books of business of other insurance companies, an insurer can position itself to grow during the next hard market.

Insurers may also predict a rise in inflation and see this as an opportunity to increase their currency values. Critics of the Fed's move say that by increasing the amount of money in circulation, the Fed's action will increase inflation, raise interest rates and lower the value of the dollar. In light of this, insurers, particularly international companies, may respond by issuing long-term debt. Having a low-cost, long-term fixed payment obligation would serve as a hedge against increasing interest rates, and investing the proceeds internationally would allow a U.S. insurer to benefit from a fall in the dollar when foreign profits are repatriated.

Insurers React to Fed Spending Elliott

The final reason has to do with insurance accounting. Recent moves to converge generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS) have placed emphasis on market-consistent balance sheets, whereby all assets and liabilities are reported at their market value. An increase in long-term interest rates would lower the market value of an insurer's previously issued, fixed-payment debt and, therefore, the insurer's reported value for this liability. This would strengthen the liability side of the insurer's market-consistent balance sheet.

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