New Financial Risks for Insurers
By Michael W. Elliott
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Many of the financial risks facing property-casualty insurers persist year after year and are well known. A large catastrophe loss, for example, would impair net income and policyholders' surplus. Additionally, a downgrade in its financial rating would likely cost an insurer many customers.

For 2010, however, U.S. property-casualty insurers face some unusual financial risks that could erode their results and they will need to get their ducks in a row.

Asset risk may be the biggest threat. Although U.S. property-casualty insurers' asset values fell and were unusually volatile during the financial turbulence of the past two years, insurers' overall return on investment assets was much better than that of many other financial firms. This was largely due to insurers' conservative investment portfolios. Most have kept the vast majority of their invested assets in high-quality, fixed-income securities, particularly bonds. However, insurers now face fixed-income investment choices that provide relatively low return and relatively high risk when compared with choices available in the past.

This unfavorable investment climate is evidenced by sagging interest rates, particularly short-term rates, which are at historical lows. Moreover, the fixed-income markets are experiencing an unusually steep yield curve with which the spread between short-term and long-term interest rates is much greater than in the past.

These factors, and the need for property-casualty insurers to continually invest the net cash inflows generated from their core business, have left them with some difficult investment decisions. Should insurers invest in long-term bonds to lock in a relatively high level of investment income despite today's relatively low yields? What is the risk that long-term interest rates will increase, reducing the fair value of these bonds? Should insurers maintain a large cash position, speculating that interest rates will soon increase and provide enhanced investment opportunities for the funds?

Interest rates at all maturities are likely to increase for several reasons related to the current economy. Given increased deficits, governments may soon be forced to pay higher rates of interest to entice investors to hold sovereign debt securities. Another factor that could buoy interest rates is price inflation, which has been low for many years. Due to the Federal Reserve's recent, and unprecedented, expansion of the money supply-its so-called "quantitative easing"-there is a great deal of discussion surrounding inflation risk, which is likely to rise when banks return to pre-recession lending levels. If the level of inflation increases, interest rates will increase as well (the so-called Fisher effect), lowering the value of fixed-income assets.

If that's not enough, U.S. property-casualty insurers maintain a relatively small percentage of their invested assets in stocks. If the world economy experiences a return to negative growth, the fair value of insurer equities would most likely fall, reducing policyholders' surplus and undoing some or all of the gains in the value of equities insurers experienced in 2009.

Liability Risk

Because of low demand with falling premiums and continued downward rate pressure, insurers also currently face an unfavorable trade-off of relatively low return and relatively high risk from their underwriting operations compared with recent years. For the first nine months of 2009, U.S. property-casualty insurers roughly broke even on a calendar-year underwriting basis, with premiums slightly less than losses and underwriting expenses. This result was aided by a relatively low level of catastrophe losses as well as the release of unpaid loss and loss expense reserves from prior accident years. If 2009 had experienced an average level of catastrophe losses and no reserve releases, the premium would have been much less than losses and underwriting expenses.

Considering the current low-return, high-risk underwriting environment, insurers should be particularly vigilant in assessing the liabilities generated through their underwriting operations. The largest liability category on their balance sheets is unpaid loss and loss adjustment expenses. Any adverse development of this liability would directly reduce net income and policyholders' surplus. Another large liability that should be monitored for adequacy is unearned premium, which has been falling overall due to the recent lower level of written premiums compared with earned premiums. An insurer should evaluate its ability to withstand errors in its estimation of underwriting liabilities by adding its loss and loss adjustment expense liability and its unearned premium liability and dividing the sum by its policyholders' surplus. The resulting reserves-to-surplus ratio, a measure of insurance leverage, can then be compared with industry averages.

A sudden increase in inflation and interest rates may not improve insurer underwriting results in the near term. The industry has no recent experience in dealing with high rates of inflation. Errors in rate making and reserving have often preceded inflation-related underwriting losses in the past. Historical industry financial data shows that the property-casualty insurance industry was unprepared for the unexpected surge in inflation that occurred from 1974 to 1976.

Perhaps some combination of a strengthening economy, rising stock markets, higher interest rates, increased inflation, adverse loss development and catastrophe losses during 2010 will cause an upturn in the property-casualty underwriting cycle and lead to higher premiums and investment returns. In the meantime, insurers need to make disciplined risk/return decisions with regard to their assets and liabilities in order to be in a position to seize future risk opportunities.

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