the hard number LLC
consulting group

Non-Bank Financial Institutions and
Financial Stability in a Regional Context

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INSOLVENCY TRIGGERS FOR INSURANCE COMPANIES

Samer Saab – Senior Partner - the hard number LLC

WHAT CAUSES INSURANCE FAILURES?

- As risk-bearing institutions, insurers can, and do, fail if risks are not managed adequately.
- Failures=company defaults (insolvency), liquidations, or regulatory takeovers (near misses).
- More often than not, it's a combination of factors reinforcing each other.
- Understanding triggers to failures helps us model stress test scenarios and better understand risk.

WHAT CAUSES INSURANCE FAILURES?

Literature identifies these main categories of triggers:

- Poor liquidity management;
- Under-pricing and under-reserving;
- Catastrophes
- Management and governance issues;
- Real economy, or sovereign risk

What causes insurance failures? Liquidity

- Insurance operating companies traditionally have less risky liquidity structures than banks, but a large number of past failures are attributable to poor liquidity management.
- Insurance companies try to match maturity profiles of assets and liabilities. Yet, several insurance failures have been triggered by concentrations in illiquid assets matched by liability structures that accelerated in a time of stress, similar to bank runs.
  - Outsized asset concentrations by single obligor or asset class
  - Outsized exposure to high risk assets.

WHAT CAUSES INSURANCE FAILURES? UNDER-PRICING

- Poor pricing strategies can lead to short-term business expansion at the expense of sustainable financial positions. Underpricing, for one, leads to negative business margins.
- The problem is compounded if poor pricing also leads to poor estimations of reserving needs, or if it compromises an insurer's capacity to reserve adequately for future claims.
- Poor policy design and pricing are the root of the issue, which are often by-products of insufficient experience in a particular business line and exacerbated by competitive pressures (the need to grow).

What causes insurance failures? Catastrophes

- Insured risk is too big for capital base, and not enough risk is passed on to reinsurance

WHAT CAUSES INSURANCE FAILURES? GOVERNANCE

- Poor risk management practices, like expanding into areas outside of core competencies.
- In these cases, liabilities were difficult for the companies to predict due to their risk management deficiencies.
- Outright fraud and poor internal controls.

What causes insurance failures? Sovereign

- The state of the economy influences business volumes and claims experience, while investment markets affect an insurer's balance sheet strength.
- For example, falling values of sovereign bond holdings can affect solvency, as seen in the recapitalization needs of some insurers following the 2012 Greek sovereign debt restructuring.
- Profitability also suffers when households and businesses confront more precarious conditions.

What causes insurance failures? Sovereign

- Insurers are typically not exempt from the effect of any deposit freeze or capital controls that may spring from a sovereign debt crisis, and this can prevent them from timely and full payment of obligations.
- In March 2013, for instance, Cypriot insurers were subject to the government-imposed "bail-in" of certain bank deposits, and they're also affected by current restrictions on bank account withdrawals and controls on cross-border transactions.

WHAT CAUSES INSURANCE FAILURES? UNKNOWN

- A 1999 comprehensive US study by A.M.BEST of 640 insurance failures found that the primary cause of failure could NOT be identified for close to a third of the cases.

Primary Causes	Number of Companies
Insufficient Reserves	145
Rapid Growth (Under Pricing)	86
Alleged Fraud	44
Overstated Assets	39
Catastrophe Losses	36
Significant Change in Business	28
Impaired Affiliate	26
Reinsurance Failure	22
Total Identified	426