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U.S. Insurers Face A New Kind Of Adversity: Their Investments

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U.S. Insurers Face A New Kind Of Adversity: Their Investments

U.S. insurers of nearly all types, accustomed to dealing with the sorts of catastrophes and other events that can cut into their profitability, now find themselves facing unprecedented adversity in the form of a severe economic slump and the investment losses that go with it.

Generally speaking, Standard & Poor's Ratings Services expects U.S. insurers to suffer more downgrades than upgrades for the remainder of 2009. This holds true across most of the insurance sectors. (The global reinsurance sector is the only one with a stable outlook, which means that we expected downgrades and upgrades to be fairly balanced over the next 12 months.)

We believe the current economic recession could linger in what is likely to be the longest and deepest downturn since the 1930s. The concurrent seizing up of credit markets is limiting many companies' financial flexibility and pressuring their capitalization, liquidity, and operating performance. Standard & Poor's outlook on the U.S. personal lines sector, for example, remains negative, reflecting our concerns about how these providers will address strained financial flexibility and liquidity and investment-related losses that are compounding pressures from weather-related activity.

Much the same can be said for life insurers, with recent market conditions hammering their portfolios, which have comparatively long durations to match their liabilities. The death and living benefit riders on variable annuities have strained capital positions and earnings, as the value of embedded options and the cost to hedge them rises in the face of a suppressed equity market. A lack of credit lines and capital market solutions to fund the reserving needs of many term life and some universal life policies continues to burden capital positions in the U.S. life sector. Meanwhile, widespread and sharp deterioration in the housing markets and the associated jump in delinquency rates on home loans have hammered mortgage insurers.

Growing Investment Risk

In short, Standard & Poor's is concerned about insurers' investment risk, particularly with respect to mark-to market valuation pressures. Though mindful that the second quarter of 2009 has offered some welcomed market relief, our economists remain guarded that high unemployment, sluggish consumer purchasing power, and lower business inventory levels could slow an economic recovery. Many companies' liquidity and debt maturity profiles have hampered efforts to hold depressed assets until they mature, until prices rebound, or until they are needed to extinguish their matched liabilities. Sustained low interest rates continue to pressure investment income, which is often a sizable secondary source of earnings.

Even reinsurance companies have felt the turmoil in capital markets, with investment losses incurred in 2008 outpacing those from Hurricane Ike, which killed more than 100 people in the U.S. and was one of the industry's costliest natural disasters. Still, for the most part, the magnitude of both catastrophe and investment losses for reinsurers was insufficient to move any ratings. But they have significantly curbed reinsurers' excess capital, even as continuing volatility in the capital markets leaves them exposed to further investment losses.

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Easing Pricing Pressures And Safer Spots

Despite this adversity, the capital erosion reinsurers have suffered could have been far worse if it weren't for their improved enterprise risk management (ERM), which helped, as losses came from both sides of the balance sheet. And many reinsurers have bolstered their competitive positions amid the turmoil in financial markets, with primary insurers' significant investment losses curbing their appetite to retain business. Perhaps more importantly, reinsurers have benefited from improved pricing for property and other short-tail lines as a result of higher catastrophe losses in 2008.

With regard to commercial lines, the pricing picture has also improved somewhat, with industry measures showing smaller annual declines in pricing. Although the pricing cycle remains an analytical concern, the declines in capital—coupled with enhanced pricing analytics throughout the industry and low interest rates (this last eliminating any temptations on the part of companies to forego underwriting profits)—make it increasingly likely that a broad pricing upturn could begin later this year. We recognize, however, that if more competitive pricing returns, or investment markets again slump sharply, our negative outlook on commercial lines could linger.

On the plus side for mortgage insurers, meanwhile, is that they often rescind or cancel policies that don't conform to a master policy establishing terms and conditions for new business. And because many players in this market could rescind loans originated under the more lax underwriting standards of 2005-2007, our base forecast calls for a reduction in future paid losses. In many cases, mortgage insurers have introduced intervention programs to help consumers stay in their homes; over the longer term, this helps moderate claim exposures.

The Credit Crunch

For many insurers, borrowing in the capital markets and the issuance of new equity have been difficult, at best. Naturally, this hurts their financial flexibility. And even as market conditions have improved a bit for investment-grade borrowers, we can't yet be certain that this is a true thawing of the credit and equity markets or simply a temporary window of opportunity for debt and equity issuers. However, the Troubled Asset Relief Program (TARP) is now available for several insurers, although many are expected to pursue capital market offerings rather than government financing.

Although some industry borrowers—such as personal lines insurers—have been able to find additional capital relatively easily, the difficult economic environment, coupled with claims payouts, has made for significant declines in surplus capital.

In any case, the future for U.S. insurers depends heavily on the prospects for the U.S. economy and financial markets, a fuzzy picture at best. Although the domestic housing market has lately shown some signs of stabilizing, and continued government action has helped calm markets, data suggest that we are far from being out of the woods. We believe that although the pace of economic contraction might be slowing, we aren't yet at the bottom.

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