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Compliance Matters

Message from the Chair

by Joseph F. Bieniek, CPCU, AIE, CCP, CIC, ARC, MCM, AIS, AU

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The recent dismal economy and the gradual economic recovery have me thinking about how we got where we are and how we can avoid traveling this path again. I believe the root cause of the economic decline is a failure on many fronts to adequately account for, measure and manage risk. Underlying the inadequate risk management is a failure to adhere to values that we, as a society, have generally strived to uphold.

There is evidence all around pointing to the decline in traditional values such as telling the truth, treating others as we would like to be treated and honoring the sanctity of a contract. The first principle outlined in the CPCU Society Creed is the following: "I will use my full knowledge and ability to perform my duties to my client or principal and place their interests above my own." This pledge has immense value and meaning to all professionals.

Clearly, many people who engaged in the risky behavior that led to the economic crisis forgot that principle. They let greed triumph over common sense and pursuit of the next transaction fee get in the way of applying sound risk management principles. Hopefully, they were not CPCUs.

Take, for example, the actions of the American International Group's (AIG) United Kingdom Financial Product Unit, run by **Joseph Cassano,** that sold credit default swaps to many large investment banks, such as Goldman Sachs, Merrill Lynch & Company (now part of Bank of America Corp.) and Deutsche Bank. Without setting aside any reserves, Cassano and other AIG employees took what amounts to bets — also known as credit default swaps, or CDS, and collateralized debt obligations, or CDOs — from these investment banks.

Richard Teitelbaum, in a Feb. 23, 2010, Bloomberg.com article[1] referencing a document Representative **Darrell Issa,** the ranking Republican on the House Committee on Oversight and Government Reform, placed into the Congressional hearing record, wrote: " ... the document and Bloomberg data demonstrate that the banks that bought the swaps from AIG are mostly the same firms that underwrote the CDOs in the first place." Thus, it appears that the investment bankers were making the toxic loans and then transferring the risk of default on those loans to the AIG Financial Products Unit, knowing full well that the likelihood of default was much higher than the AIG Financial Products Unit was led to believe.

The opacity of the CDS and CDO markets enabled the investment bankers to profit from the transaction fees generated by initiating the loans, and again from packaging the loans into CDS

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or CDOs, and further by off-loading the risk to another entity — in this case the AIG Financial Products Unit. Failure to meet obligations assumed on these toxic assets led the AIG Financial Products Unit to default on its obligations, which led to downgrades of the entire AIG operation with a trickle-down effect to its insurance entities.

This example shows we have an ethical values crisis in addition to an economic crisis. It is my contention that if we do not address both, then history is bound to repeat itself. We need to take a good hard look at the values we espouse and are willing to carry out. And, as the CPCU Creed says, we must place the interests of others above our own. All parties must deal in open and ethical ways. We must be willing to disclose all pertinent facts to a transaction and not hide some of them to gain an economic advantage.

We need to replace current business methods where one party takes advantage of another in an opaque environment with an open and transparent system where all risks are disclosed and properly measured. All parties need to be able to place an appropriate value on any contract issued. We need to embrace a new paradigm where transparency is favored over opacity. If all this occurs, we will be able to restore confidence in the American economy and get it moving again.

This ethical sea change needs to start with basic family values. We need to get rid of our "I want it all and I want it now" attitudes and replace them with concern for our fellow man. Profiting from economic transactions is not evil; however, it can become so if we treat counterparties in unethical ways. We need to replace greed with service to humanity and teach our children to do the same. The ability to make a reasonable profit is part of the American economic system. It is the engine that drives the economic train. Without it there is no incentive to conduct business. We simply need to make it fair once again.

It seems to me there are two possibilities we face as a nation: We can either work hard to regain our societal values and treat each other with respect and honesty, or we can engage in a race to the bottom that will send us on the same path as the Roman Empire. We also have choices about how this occurs. Two choices come to mind: We can either have Congress develop legislation that forces us to act ethically, or we can rebuild our economic engine with good old American ingenuity. This issue of *Compliance Matters* contains several articles that explore ideas that can right the ship. I hope you will enjoy them.

March was Ethics Awareness Month for CPCUs. This time of year provides a perfect opportunity to remind ourselves that being a CPCU brings with it a sacred obligation to abide by the Code of Professional Ethics of the American Institute for CPCU.

As CPCU Society members, we also must uphold the CPCU Society Ethics Code, which is divided into two sections. The first section lists eight specific unethical practices that Society members must avoid. A CPCU Society member shall not:

- Violate any law or regulation duly enacted by any governmental body whose authority has been established by law.
- Willfully misrepresent or conceal a material fact in insurance and risk management business dealings in violation of a duty or obligation.
- Breach the confidential relationship that a member has with his client or with his principal.
- Willfully misrepresent the nature or significance of the CPCU designation.
- Write, speak or act in such a way as to lead another to reasonably believe that the member is officially representing the Society or a chapter of the Society unless the member has been duly authorized to do so.
- Aid and abet in the performance of any unethical practice proscribed under this Section.
- Engage in conduct which has been the subject of a presidential or Board of Directors directive to cease and desist.
- Engage in any act of a retaliatory nature against another person reporting or providing evidence of an ethics violation.

The CPCU Society Ethics Code also contains three general admonitions. A member shall not:

- Engage in practices, which tend to discredit the Society or the business of insurance and risk management.
- Fail to use due diligence to ascertain the needs of his or her client or principal and shall not undertake any assignment if it is apparent that it cannot be performed by him or her in a proper and professional manner.
- Fail to use his or her full knowledge and ability to perform his or her duties to his or her client or principal.

The CPCU Society Ethics Code is available at the Society's website: http://www.cpcusociety.org/page/65790/.

I hope this ethical discussion has been worthwhile. I would be glad to hear your thoughts on ethics and on the several initiatives that are either underway or being considered. We need to work together to ensure that everyone maintains high ethical standards and does not let excessive greed lead to the downfall of our society. Fair dealing needs to become the way business is always done. ■

Reference

1. Richard Teitelbaum. "Secret AIG Document Shows Goldman Sachs Minted Most Toxic CDOs." Bloomberg.com: Feb. 23, 2010 <http://www.bloomberg.com/apps/news?pid=20601087&sid=ax3yON_uNe7I>

Comments from the Editor — It's a Brave New World

by Eric C. Nordman, CPCU, CIE

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Editor's note: The opinions expressed in this article are those of the author and may or may not be consistent with the opinions of the NAIC membership collectively or any of its members individually.

It's been more than 10 years since Congress fixed the problems with regulatory oversight of banks, securities firms and insurers by enacting the Gramm-Leach-Bliley Act (aka the Financial Services Modernization Act of 1999) and getting regulators out of the way of those wishing to profit from various sophisticated financial instruments by enacting the Commodity Futures Modernization Act of 2000. Our reward for their efforts was the worst recession since the Great Depression that still somewhat lingers on with chronic unemployment and volatile financial markets, despite all sorts of statements by learned economists that we're out of the woods.

Trillions of dollars in at least nominal value have been lost from our economy, and the recovery has been excruciatingly slow and painful. Don't despair! Things will actually get better from here. This newsletter will focus on some new developments in the world of high finance and offer some food for thought on how the recovery can come more quickly, with positive benefits for us all. However, before we provide any solutions, it is important to understand how we got here.

Losing Sight of Lessons Learned from the Great Depression

Lesson One — Combining Divergent Financial Businesses Can Spell Trouble

In the 1990s, everyone thought that consumer demand would drive the convergence of banking, securities and insurance. It was this belief that led to the Citibank and Travelers merger — heralded as a watershed event in its time. Congress had been debating financial services modernization concepts for nearly 20 years. On April 7, 1998, Citigroup Inc. was formed as the result of a merger between banking giant Citicorp and the financial conglomerate known as the Travelers Group, best known for its property-casualty insurance operations but also owner of securities firm Smith Barney.

The $140 billion merger created what was then the world's largest financial services organization. The thought behind the merger was that Travelers would be able to market mutual funds and insurance to Citibank's retail banking customers while Citibank would be able to access an expanded client base of investors and insurance buyers to cross-sell banking products.

The personalities behind the scenes were **Sandy Weill,** chief executive officer of Travelers, and **John Reed,** chairman and chief executive officer of Citibank. Both Weill and Reed were fond of the Travelers distinctive logo, the red umbrella. Thus, the red umbrella became the symbol for the combined operations. Soon after the merger, it became apparent, however, that the personalities and management styles of Weill and Reed were not a good match. Initially co-chairmen and co-CEOs, Weill and the Travelers/Smith Barney crowd soon drove out John Reed.

At the time of the merger, the Depression-era Glass-Steagall Act (the Banking Act of 1933) was the law of the land. It established the Federal Deposit Insurance Corporation (FDIC) and contained a number of provisions meant to control the rampant speculation that was characteristic of the 1920s. It is Glass-Steagall that introduced the separation of banks into commercial banks and investment banks. It also required that banks be separate from insurers and from securities firms.

When Weill and Reed decided to proceed with the Travelers-Citibank merger, they did so fully aware that if Congress did not act to change the current law, elements of the merger would have to be undone within a two-to-five-year period. They were successful. President **Bill Clinton** signed into law the Gramm-Leach-Bliley

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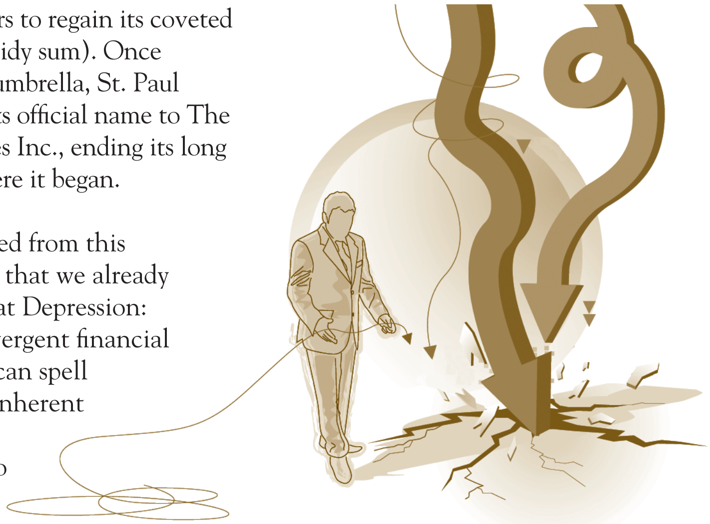
Act on Nov.12, 1999, which repealed the Glass-Steagall Act; facilitated affiliation among banks, securities firms and insurers; and opened the door for financial services conglomerates to offer a mix of commercial banking, investment banking, insurance underwriting and brokerage — all under one roof (or umbrella).

Mixing the property-casualty insurance business with the banking business can be a problem. Banking products and services are intended to make people happy — paying interest on deposits, making important loans for houses and cars, etc. The property-casualty insurance business can be a bit less friendly. Disputes over claims, unhappiness with the price of auto and home insurance, and the volatility of underwriting results — on a seasonal and catastrophic basis — can lead to unhappy customers and cause stock prices to fluctuate dramatically. In the case of Citigroup Inc., the banking end of the business found it did not gain much ground, as the Travelers insurance customers sought their insurance coverage from independent insurance producers — not from Citibank.

Citigroup Inc. spun off its Travelers Property and Casualty Corp. insurance underwriting business in 2002. The Travelers Property Casualty Corp. merged with The St. Paul Companies Inc., forming The St. Paul Travelers Companies in 2004. This left Citigroup, at the time, with its life insurance and annuities underwriting business. These businesses were later sold to MetLife in 2005. Citigroup still sells all forms of insurance, but, as of this writing, it no longer has any insurance underwriting operations.

Even though Citigroup sold all of the Travelers insurance operations, Citigroup retained Travelers' signature red umbrella logo as its own until February 2007. With 20-20 hindsight, we now know the two cultures clashed, leading to a messy divorce that spun off the Travelers insurance operations and culminated in a behind-the-scenes deal that eventually allowed the Travelers to regain its coveted red umbrella (for a tidy sum). Once it obtained the red umbrella, St. Paul Travelers changed its official name to The Travelers Companies Inc., ending its long journey back to where it began.



The lesson re-learned from this experience was one that we already knew from the Great Depression: Namely, mixing divergent financial services businesses can spell trouble. There are inherent conflicts of interest that make it risky to mix the granting of credit or lending and the use of credit or investing in the same entity. Further, the sale of securities involves substantial risk, leading to potentially enormous losses of value that might threaten the integrity of bank deposits, particularly if they are also the source of the capital to be invested. Commercial banks are supposed to manage their investments prudently, and their managers might not be able to prudently limit risk when the Sirens of higher-but-quite-speculative investment returns come calling. It is abuses of this nature that had first led to the enactment of the Glass-Steagall Act.

Lesson Two — If You Let People Bet on Something, They Will ... and a Neutral Third Party Should Hold the Payoff if You Want to Collect (Unregulated Synthetic Securities Can Be Lethal)

Lesson No. 2 starts with a brief story as well. It has its roots in the same time period as our first lesson. We have always known that capitalism is driven by fear and greed. Generally, the fear keeps the greed in check. Occasionally people forget the fear part of the equation, and greed runs rampant as a result.

While on one hand, the various laws which authorized the securitization of loans brought tremendous amounts of capital and volume into the mortgage and commercial loan markets, they also facilitated a masking of the underlying real risk so that the buyer of the security was unable to see the performance of the specifically designated underlying assets. This concept of creating synthetic securities spilled over into other markets with devastating results.

In addition to problems with subprime mortgages and the related mortgage-backed securities, there is another type of derivative that has been of concern in these trying economic times. It is the credit default swap (CDS). The credit default swap comes in two flavors. The first is the covered credit default swap where the buyer owns a security and seeks to "insure" against the security declining in value. The "insure" is in quotes because one could argue that a credit default swap is really an insurance product.

In fact, you can purchase a credit default swap by another name. It is called financial guaranty insurance and is sold by a few specialty monoline financial guaranty insurers. That said, most credit default swaps are not claimed to be insurance products and are not regulated as such — at least not yet. Moreover, the underlying principles of financial guaranty insurance were turned topsy-turvy by these synthetic securities. Today, CDS-related risks number a record notional or face value of $700 trillion (not market value), worldwide, of which we created the lion's share[1].

The easy answer if one is concerned about the default of the issuer of a credit security is for the buyer to sell the security and eliminate the exposure to loss. This simple approach is not taken because there is an incentive built into the banking system for banks to buy either credit default swaps or financial guaranty insurance. The reason is to avoid regulatory capital requirements. Banks are required to hold a certain level of capital to back up their loans and investments. Bank regulators accept credit default swaps and financial guaranty insurance to show there is no risk of default and, thus, no need for capital to support the loans or investments. Recent market problems demonstrate the position of the banking regulators is a bit shortsighted.

The second type of credit default swap is the "naked" credit default swap. In a naked credit default swap the buyer does not own the underlying security and thus is not at risk of financial loss. Nevertheless, the buyer and seller reach an agreement for the seller to pay the buyer as if both the buyer really owned the underlying security and the issuer of the security defaulted on the payments called for related to the security. In many circles, this transaction is called a bet. The buyer is betting that the security issuer will default, and the seller is betting the issuer will not default. Neither party had any risk until the credit default swap contract created it. While on the surface this situation might not seem so bad, a bit of history and a look back at how the market had grown before collapsing might tell a different tale.

In the 19th century, there existed what was known as "bucket shops." A bucket shop was a business that had a New York Stock Exchange ticker available to it. The bucket shop would post stock quotations as they came in, and the customers could bet on the ticker-tape value of a stock instead of purchasing it. If the underlying stock rose, the customer made a profit. If the underlying stock price declined, the customer lost. The business also always received a commission for underwriting the bet. This is known as the "vig" in Las Vegas. It is the amount charged by the bookie for his services. It worked the same way for bucket shops as it does today for commissions on credit default swaps. The bucket shops were largely responsible for the economic Panic of 1907, and to address the situation, states enacted statutes to outlaw bucket shops soon after.

Things went relatively well until the late 1990s — the Crashes of 1929 and 1987 excepted. At the time, there was a push to modernize financial services regulation, and the old anti-bucket shop laws were viewed as a vestige of a bygone era. Surely, with modern computer modeling techniques, investors would be able to manage risk and reward. This conclusion led Congress to enact on Dec. 15, 2000, and President Bill Clinton to sign six days later, the Commodity Futures Modernization Act of 2000. The bill was supported by Federal Reserve Chairman **Alan Greenspan** and Deputy Secretary of the Treasury **Larry Summers** in their leadership roles for the President's Working Group on Financial Markets. They wrote, the working group "strongly supports" the bill ... it helps the U.S. maintain its "competitive position in the over-the-counter derivative markets by providing legal certainty and promoting innovation, transparency and efficiency in our financial markets."

The President's Working Group was at least partly correct (although in April 2010, Bill Clinton said he had received "bad advice" from both Treasury Secretary **Robert E. Rubin** and Summers). Freed from the shackles of the pesky state laws prohibiting gambling and bucket shops, the credit default swap markets grew from roughly $900 billion in 2001 to over $46 trillion in 2008. Much of the growth occurred in the trading of naked credit default swaps. In the now unregulated environment, the credit default swap market seemed to be thriving. The President's Working Group was right about the U.S. leadership role, but it missed the part about transparency and legal certainty. We will revisit that thought later in this article.

With trillions of dollars in notional value in naked credit default swaps floating around, it was only a matter of time until the house of cards fell down on itself. We all had to learn about a new concept — contagion, or systemic risk. Systemic risk is the risk that financial difficulties at one or more financial institutions will impact other financial institutions or the economy in general. In the case of credit default swaps, the default of one issuer led to calls on swaps that other sellers were unable to cover, leading to a domino effect that hurt the U.S. and world economies.

One particularly poignant example that best describes how this business works is a recent lawsuit filed by the Securities and Exchange Commission against Goldman Sachs. In the complaint[2], it is alleged that **Fabrice Tourre,** a Goldman, Sachs & Co. employee, made materially misleading statements and omissions in connection with a synthetic collateralized debt obligation (CDO). The CDO in question was tied to the performance of subprime residential mortgage-backed securities (RMBS).

Goldman Sachs developed and marketed the CDO to investors at a time when the market was beginning to show signs of distress. The complaint alleges that this type of CDO contributed to the financial crisis by magnifying losses associated with the downturn in the housing markets. The disclosures and advertising materials represented that a particular respected firm with expertise in analyzing credit risk in RMBS selected the portfolio of mortgages included in the offering. What was not said in the offering was that another hedge fund participated in the portfolio selection *and* that the hedge fund purchased a credit default swap to cover its risk.

With the credit default swap in place, the hedge fund now had a perverse

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incentive to select mortgages that would be more likely to fail in the near future. Goldman Sachs neither disclosed the hedge fund's adverse interest nor its participation in the selection of the mortgages included in the CDO. The end result was that investors lost over $1 billion, while the hedge fund's credit default swaps generated approximately $1 billion for the fund. Goldman Sachs made about $15 million in commissions for structuring and marketing the deal. Is it any wonder that the markets are not performing very well today? Still, today the disclosure responsibilities for intermediaries remain somewhat unclear, as indicated by the dissenting votes of two SEC commissioners.

Perhaps the closing paragraph to an article[3] written by economist **William J. Quirk** says it best. Quirk says, "We need to try to correct the harm done by the infamous Section 17 of The Commodity Futures Modernization Act of 2000. Let the sun shine into this secret market. Let's disclose all the facts so we can finally figure out who owes what to whom. That would be a beginning."

The lessons re-learned from this experience we already knew from the Great Depression. Namely, if you let people bet on something, they will; and, if you don't have a neutral party holding the money, sometimes people won't get paid what they expect. We were wise to prohibit gambling on events where neither party has a financial stake. We need to think about repealing the Commodity Futures Modernization Act of 2000 and restoring some discipline to the markets.

Calls for More Regulation, Enhanced Disclosure and Market Transparency

Now that the history lesson is complete, it is time to take a look at some recent developments that might help define a better future. Following the economic decline attributed to the fall in housing prices combined with the over-reliance on the sustainability of credit markets, many policymakers talked about the need for greater regulation, increased disclosure and transparency. These policymakers are correct. However, the devil is in the details. What is going to be regulated and how? What must buyers disclose? What steps can be taken to assure an acceptable level of transparency?

There are some exciting new ideas and approaches being considered. Congress is hard at work trying to figure out how to stay one step ahead of Wall Street. In May, the Senate passed S. 3217 — Restoring American Financial Stability Act of 2010. This bill creates the Financial Stability Oversight Council, a mechanism for granting resolution authority to the federal government, and a Bureau of Consumer Financial Protection; it also gives the Federal Reserve authority over some systemically risky nonbank businesses.

The House had previously passed H.R. 4173 — the Wall Street Reform and Consumer Protection Act of 2009. The legislation creates a new federal agency called the Consumer Financial Protection Agency (CFPA) to protect consumers from unfair and abusive financial products and to help protect against destabilizing the economy. The CFPA will set standards for financial products and will have regulatory oversight over payday lenders and mortgage originators — two previously unregulated segments of the financial services world.

H.R. 4173 also outlaws many of the more egregious activities that led to the subprime mortgage crisis and record foreclosure rates. Predatory lending activities are curtailed, and elements of fiscal responsibility are added by requiring lenders to adhere to sound underwriting principles (such as making sure a borrower can repay a loan and prohibiting the so called "liars loans.") The bill also attempts to rein in some of the more irresponsible compensation practices that encouraged executives to take excessive risks by allowing shareholders to have a nonbinding vote on executive compensation, and it also requires disclosure of incentive-based compensation practices.

H.R. 4173 closely regulates large interconnected, systemically risky firms and ends taxpayer buyouts of them through creation of a dissolution fund, apparently funded by the industry. The SEC's enforcement powers are enhanced to avoid financial fraud and improve investor protections.

Reactions from the Private Sector and Government

While Congress debates a new regulatory framework, there are also important developments in the private sector that, if successful, should improve matters. This newsletter contains several articles about these developments. There is an article by NAIC Economist **Aaron Brandenburg, ARM,** describing the development of an Insurance Exchange initially targeted to commercial lines businesses. In a unique partnership, the Council of Insurance Agents and Brokers (CIAB) and information provider Lexis/Nexis have come together to develop a Web-based electronic insurance exchange for insurance producers. The CIAB-Lexis/Nexis insurance exchange employs a business process patent and associated intellectual property developed by and licensed to them by Marketcore Inc. (See www.marketcore.com.)

In this issue, there is an article by **Michael Erlanger,** a principal in Marketcore Inc., that describes how the Marketcore business process can quantify and reduce risk to help restore financial markets to good health. The reason his invention works for capital markets products is twofold. First, if an electronic system is developed to enable the transactions and capture the transaction data, the administrative costs to all parties to the transaction would be reduced. Second, there is always a cost of risk associated with a capital markets product that is related to uncertainty. The greater the uncertainty, the greater the cost of the element of the capital markets product associated with the transfer of that risk between the parties. If the uncertainty surrounding the risk is reduced, then the cost of risk is reduced and the overall cost of the product is reduced.

The Marketcore invention appears to reduce uncertainty and enable a more complete identification of risk in financial products. All parties to the transaction benefit from the reduced transaction costs. The purchaser of the product will also benefit from the reduced risk-based cost because of improved transparency and more complete knowledge regarding the risk transfer. The seller will benefit from greater transaction volumes resulting from greater confidence in the certainty of the outcomes and from information gleaned from the transaction data.

There is also an article that ran in the last edition of this newsletter which we are repeating in this issue. Co-written by **Stewart A. Keir, CPCU, CFE,** and **Robert A. Romano, J.D.,** the article, "New York Working to Re-Establish the New York Insurance Exchange," provides information and insight into why New York has established a working group to investigate how to re-establish the New York Insurance Exchange and to address the shortcomings that led to its earlier demise. Enabling legislation adopted in 1978 remains on the books. Those studying the issue will need to consider whether there are structural flaws in the legislative framework that call for revision to make the New York Insurance Exchange a success this time around. Perhaps policymakers evaluating how the New York Insurance Exchange could work better this time might consider making transactions transparent and collecting analytical information about the risks being transferred.

The National Institute of Finance

The Committee to Establish the National Institute of Finance has recognized that we, as a nation, have insufficient information to effectively monitor market performance. Its focus is on systemic risk. The National Institute of Finance, as advocated by the committee, would plug the gaps in the nation's understanding of financial markets and how they affect the broader economy. The proposal would fill those gaps by accumulating pertinent data and enabling the analytical capacity to turn the data into useful information to inform policymakers and regulators to help safeguard the economy. The Committee to Establish the National Institute of Finance (CE-NIF) is a private group that consists of academics, regulators and financial sector experts who believe that collection of this information is critical to our future financial health as a nation. More information on the CE-NIF can be obtained at www.ce-nif.org.

Insurance Exchanges and Health Care Reform

The concept of insurance exchanges has been included in the recently passed Patient Protection and Affordable Care Act (PL 111-148) and the Health Care Education and Reconciliation Act of 2010 (PL 111-152), more commonly known together as health care reform legislation. Congress recognized that more regulation, enhanced disclosure and greater market transparency would be good for health insurance markets, too. The health care reform legislation is perhaps the most comprehensive domestic policy legislation enacted since the Great Depression.

The health insurance exchanges envisioned by the health care reform legislation must be governmental agencies or nonprofit entities created by the states. Their purpose is to match willing buyers of health insurance with willing sellers and to provide buyers with consistent, transparent and understandable information to assist buyers with choosing a health insurer and a benefit plan. Transparency will be further enhanced by requiring the development of an online calculator to estimate premium and identify any cost-sharing elements of coverage. The health insurance exchanges will assign a rating of each health plan with regard to quality of service and price to help buyers with the selection process. A common application

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form will be developed to provide uniformity of underwriting information throughout the nation.

The legislation contemplates two separate insurance exchanges — one for individual policies and one for small business policies. A state can choose to combine the two risk pools into one insurance exchange if it wishes. If states wish to band together to form regional exchanges, that is also permitted. The exchanges are required to establish an Internet website where enrollees may obtain standardized comparative information about the health plans. They also must operate a toll-free telephone hotline to assist callers with plan selection and to respond to questions.

Convergence

Earlier in this article, I mentioned that we once thought consumer demand would drive convergence of insurance, banking and securities. We now know that a different force is in play. Whether a product is classified as an insurance product, a banking product or a securities product is often defined by who is selling it and who is regulating it. For example, there is little difference between a financial guaranty insurance product and a credit default swap. Yet one is regulated as an insurance product and the other is not currently subject to much regulation at all. I will leave to the reader to speculate about why there are significantly more credit default swaps than financial guaranty transactions.

Similarly, there is not much difference between a credit life insurance policy and a debt cancellation agreement. A credit life insurance policy pays off the outstanding balance on a loan if the borrower dies. In a debt cancellation agreement, the bank agrees to forego collection of the outstanding balance on a loan if the borrower dies. The risk is premature death of the borrower in either case.

In any event, every financial services sector product has at its heart an element of risk. For mortgages, loans and lines of credit, financial guaranty insurance and credit default swaps, the risk is default by the borrower and, in many situations, the market value of the underlying collateral. For retirement security products such as annuities, pensions, and a variety of bank and insurance products, the risk is outliving one's assets. For other life insurance and banking products, the risk is premature death. Thus, instead of consumer demand, it is the way in which risk is defined that is driving convergence.

We need to take a look at the impact of these different ways of looking at and evaluating risk. There certainly is some benefit in making sure there is no regulatory arbitrage occurring that influences whether a risk is defined in a certain way. We need to create electronic systems to capture and evaluate risks regardless of type, and to link risks together so regulators and the public can effectively monitor whether a party or counterparty is likely to make good on the risk exchanges to which they are committed — regardless of whether we now think of the risk as an insurance risk, a banking risk or a capital markets risk.

Conclusion

We humans have a tendency to try to fix that last known problem. We need to take a more forward-looking approach. We know that there is a lack of transparency in markets today. We also know that the lack of transparency is a result of claims of proprietary information and because the dealmakers believe they can make more money off transactions if the instruments they develop are a bit mysterious. We can no longer afford to adhere to this mantra.

We need to insist that transparency becomes the modern way to do business. This should apply to insurance products, banking products, capital markets products and securities. We must insist that all of these financial services transactions occur in the sunlight and that systems be developed to capture the information underlying the transaction. We need to look to the leading thinkers, such as the Committee to Establish the National Institute of Finance and Marketcore Inc., to bring these ideas to fruition. The various insurance exchanges may provide us with the vehicle we need to move toward a more transparent marketplace where counterparties can trust each other and the truly informed and watchful eye of multiple regulators will keep everyone honest. ■

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Back to the Future — The Journey of Insurance Regulation

Tuesday, Sept. 28 • 9:45–11:45 a.m.

Many of the insurance regulations that were passed early in the 20th century became the underpinning of today's insurance industry. Insurance regulation, both federal and state, continues to be critical in providing a stable financial platform for a free market economy. In late 2009, what took years to build was questioned overnight. Our entire industry, as well as its laws and regulations, were placed under examination by the public and by political leaders. It is certain that Congress and local regulators will take corrective action. But what will future generations say about our industry and the impact of regulation and laws that are being passed today? Will they stand the public test if our industry falters again? This seminar will be fun and enlightening for anyone in the insurance industry

Moderators: Rick Jones, CPCU, ARM, SCF Premier Insurance Company; Eric C. Nordman, CPCU, CIE, National Association of Insurance Commissioners

Presenters: Angelina Banks, J.D., CPCU, NCCI Holdings, Inc.; Joseph F. Bieniek, CPCU, AIE, CCP, National Association of Insurance Commissioners; Robert H. Card, CPCU, CLU, MBA, National Association of Insurance Commissioners; James Fryer, CPCU, Ed.D., Pearson VUE; Bradley K. Harmes, CPCU, ARM-P, Marsh's National Public Entity Practice; Keith E. Langan, CPCU, J.D., Fireman's Fund Insurance Company; Aaron E. Lunt, CPCU, J.D., ARe, Zurich North America; and John Reiersen, CPCU, CIE, CFE, Kingstone Insurance Company.

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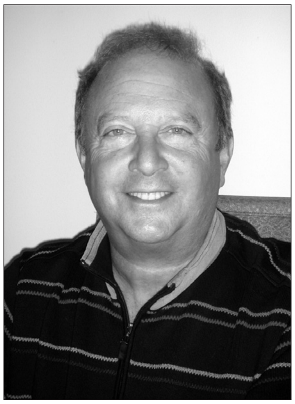
Insurance Investments and Disclosures — How One Business Process Can Reduce Risk and Restore Finance

by Michael Erlanger



Michael Erlanger is a founder and co-managing principal of Marketcore Inc., an intellectual property development company based in Westport, Conn. His career in financial services spans 50 years, most of which was spent on Wall Street, where he consistently ranked among the top revenue producers as a corporate bond broker, trader, institutional salesman and department head. Subsequently, Erlanger co-founded two other profitable Wall Street boutiques, including IPEX LLC, an institutional whole loan brokerage and boutique investment bank which was predecessor firm to Marketcore. He is a graduate of Columbia University.

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In questioning how they could have missed such a large failure in our national financial system, legislators and regulators alike have asked, "How do we connect the dots?" The answer is apparent: "In order to connect the dots, we must first be prepared to see the dots." This requires new business processes that look at information in greater detail. In fully connecting financial transactions to their risk-describing elements, we stand at an historic nexus of national strengths: financial market creation and information technology. We can improve our systems to overcome the errors we have made in the past. Then, we all can go back to work.

How Can We Step Away from the Brink and Begin Restoring Our Financial System?

It is incumbent upon us all to create a viable and constructive solution that preserves the health of our economy. To that end, we must implement tools with which to properly identify, manage and value investment risk.

Marketcore proposes just such a solution. The solution rests on improving the quality and timeliness of disclosures in order to:

- Empower regulators to more effectively oversee financial institutions and detect emerging systemic risk, without overly burdensome regulations.
- Empower investors' decision-making.
- Stabilize markets through improved price discovery, enhanced risk identification and facilitated market liquidity.
- Expand business opportunities.
- Improve the functioning of both insurance and capital markets.

A Single, See-Through Solution

We propose a continuous framework for understanding risk in which all market participants are directly rewarded for being transparent and for updating their disclosures. The process would occur in a linkage of financial market functions that result in an effective unified data processing system encompassing the entire financial sector. It would be marked by a viral growth of increasingly granular market data that would reduce the abusive impact of information arbitrage.

In this patent-protected business process, each set of disclosures is matched with an incentive of a direct financial or strategic benefit that lowers costs of either subsequent transaction fees or access to critical market information, with anonymity given to the data to address privacy concerns. The benefit, a "Transaction Credit™", is granted for a specific term for conversion to specific services, whether the market participant is either creating a product, intermediating a product, shedding or taking on risk. Financial performance would be tracked in near- or real-time by the benefit of "Transaction Credits" which offer a direct non-inflationary stimulus to business volumes, from first inquiry to final placement of each and every financial contract with an investor.

The result is clarity of purpose and risk reduction. The incidence of fraud would decline with the disclosures, as would the cost of each related risk transfer. With an eventual end to the twin issues of informational asymmetry and its accompanying adverse selection, markets could actually afford to gradually replace risk-related business inefficiencies with growing business volumes, as market functions are restored. Data analytics could present electronic information that could fully span the most micro- to the most macro-market views for improved risk management.

In a nutshell, what is being proposed is an electronic communication system that links those with risks they wish to transfer to those wishing to profit from accepting risk transfers. The difference between what exists today and the proposal is that *all parties will have access to the same information in the electronic communication system* that captures the important descriptors of the risks being transferred.

The transparency embedded in the system will work to restore the sanctity of the contract — a feature that has been lost in our current environment. The risk shedder will know the cost of the risk transfer and will have to, in good faith, disclose all the important risk characteristics so that the risk acceptor understands exactly what is being transferred. This will allow the marketplace and its regulators to confidently evaluate the risk and appropriately account for it, restoring faith in our free market system.

Leveling the Playing Field

Insurance regulators focus on an insurance carrier's market activity (which defines business practices in risk terms) and solvency (which protects the financial integrity of the company). This dual regulatory focus arises from the fact that an insurance carrier's core product (the contractually-promised protection of a defined risk for a defined term) is largely supported in each insurance carrier's asset base by investments in an aggregate of secured assets with determined cash flows (mostly bonds). As a result, insurance companies are among the most significant participants in related financial markets and among the largest investors in specific types of financial instruments — e.g. securitized instruments backed by mortgages being one type with current valuation and liquidity problems.

Currently, at least in terms of information within the insurance markets, investment decisions and transactions occur on a very uneven playing field. The revelations of the past two years confirm that a dramatic asymmetry exists in both the flows of information and critical risk data disclosures surrounding the precise risk elements of various instruments (as described by **George Akerlof, Michael Spence** and **Joseph E Stiglitz,** and acknowledged in 2001 with a Nobel Prize in Economics).[1]

As predicted, this asymmetry has worked to the distinct advantage of a very few, and the gross disadvantage of the many, and can be seen to have undermined the entire chain of investment decision-making. Asymmetrical flows of information contribute to, and in turn are greatly facilitated by, opaque markets. Some might add that they have actually combined with the reality of uncertain per asset cash flows to exacerbate the financial crisis. However, market participants are able to identify, and properly manage or hedge risks in those cases where there is disclosure of timely and relevant information about each risk element.

Each contract's risk is defined by its underwriting standards, representations and warranties, price, terms and conditions. It is precisely here that we first run into problems with both disclosures and "transparency." Market transparency is simply defined as full access to information. However, in a marketplace with asymmetric information flows and limited synchronicity of data, opacity can often favor only one of the contractual counterparties. The result: *fraud is rampant* and the market can often be characterized by a wish to shun, or delay, honoring contractual obligations. For finance, relying as it does on the sanctity of a contract and of full disclosure, this has resulted in a near death experience — at least for parts of

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the market where the specific financial performance can no longer be reliably predicted for individual assets.

However, in an information age, disclosures and transparent data flows are capable of being joined. The ability to view risk data electronically in near- or real-time from both macro and micro views is particularly useful when it is necessary to value complex, rarely traded and unique aggregations of contracts, such as those that commonly occur in both the property-casualty sectors of insurance and the structured finance sector of capital markets. What could be more useful and restorative for asset and risk valuation purposes than an effective, electronic "ticker tape" on both the insurance and lending markets?

Once established through product differentiation in the spot markets, we could even grow future and options markets to hedge risk in the newly differentiated asset classes. As has been proven in other markets, this can best be accomplished through a near- or real-time electronic exchange and tracking of both descriptive data and price/term information. This is easily combined with on-going performance or cash flow reviews, even down to a granular, per contract basis.

Market Application

An illustration of the following example of an application of the Marketcore data processing system is provided in a demo on our website, www.marketcore.com. Marketcore's system has direct application in the credit and credit derivatives markets. Our system is designed to encompass any portion of, or the full spectrum of, a loan origination, from the first inquiry by a consumer to the final maturity or end disposition of the loan. The information that describes the origination of a loan and all related risk and valuation data is entered into the system, where it becomes transparent and trackable. These defining risk parameters of each loan can be provided or displayed anonymously, in real time or near real time. It is always accessible to all market participants, including regulators, rating agencies, investors and market makers.

The data can be accessed to take as macro or micro a view of overall market or product-specific or transaction-specific information and activity as the user desires. A lender's underwriting standards describe the risk that he is willing to take. It is those risks that can be shifted to others downstream. The loan documents further specify the obligations of each counterparty to the financial contract. This data will always be accessible no matter what happens to the loan — even if it gets sliced and diced into derivative products that use only a portion of the original loan instrument.

As the loan ages, its performance is tracked. The performance and other related risk data is stored in the database where it can be tracked for the life of the loan. Each descriptive element and any changes are embedded and stored in a Transaction Credit™. The Transaction Credit, in turn, has direct financial benefit to the participant. Thus, all market participants have the optional ability to "trade" transparency in exchange for lower costs. A Transaction Credit is a unique, anonymous identifier that can be applied to reduce the cost of future transactions, or of strategically important market information. It is also a tracking device. Transaction credits continuously add information and value, even as the loan ages, enhancing liquidity and powering business volumes. This unique tool provides incentive for participation and tracking risk characteristics of each instrument.

At each point along the way:

- Data is collected, linked and tracked.
- Data is viewed in real time.
- Transaction Credits are earned — reducing costs.

As a loan is held in an investment pool, the details of the individual loans and pricing characteristics must be fully and accurately known and described. Today, this information is difficult, if not impossible to obtain. But in the Marketcore system, any loan within the portfolio can be made fully transparent down to the key data elements. The precise original underwriting standard can be accessed and compared against other risks. And those data points can be used to create new informational or investment products. Wherever it goes, no matter how many times it is repackaged and resold, the data associated with that loan remains in the data processing system, fully transparent for all market participants.

Participants can view in the system, the data of the specific loan, lending activity in the retail market, and transactional activity in the secondary market and all related risks. Participants can compare performance of the loan, and of all related products based off of it. Thus, regulators can detect disturbing market trends as they emerge.

Over time, a rich repository of market data is formed. The display of data in real time creates a "ticker tape" on the markets for loans and lines of credit, which has never existed before. This will enable price discovery, the tracking and establishment of asset values. It provides a methodology of ascribing reliable asset values and credit ratings to securitized and structured products. This in turn creates more efficient markets by exposing differences in market pricing, which both provides arbitrage opportunities, but at the same time limits excessive arbitrage, leading to more robust financial markets.

Timely access to loan data, compared across transaction platforms, can be used to identify particular bellwether events such as systemic risks and concentrated counterparty risks, shifts in borrowing activity, loan repayments, refinancing activity, or resale of derivative risks and much more. Participants can track and model these data points to assess the actual performance and risk profile of assets.

The Marketcore system facilitates identification of impending toxic trends, excessive inventory by loan type and other warning signs, thereby "connecting the dots" to form a comprehensive view of systemic risk. With this information in hand, the owner, investor, evaluator or regulator can take the appropriate steps to manage the risk.

Marketcore's system is neutral, low-cost, and assures enhanced market liquidity, growth and function. The solution defines transparency as it clarifies risk. And this system has application across all financial markets.

Are Such Concepts Actually Feasible for Use Today?

Yes. The intellectual property that surrounds this work has recently been licensed for use in the commercial marketplace for insurance and reinsurance. This initial use, a single policy submission to multiple carriers, is only one efficiency-creating application of this unique business process. It focuses simply on the origination side of insurance, without links to capital markets. Still, it is being used to address critical operating inefficiencies and market standardization issues and will lead to transparency for financial market intermediaries as well as to better risk management and pricing.

Stabilizing Markets, Expanding Business Opportunity

The only way to grow such a complex marketplace is to enhance the product-creation process and to assure that the risks are both appropriately measured and "costed" to the intended investment result. In this way, it is possible for the product origination process and the anticipated financial performance of each contract to secure the marketplace.

A frank and transparent identification and grading of all contractual and associated risks in product creation will enable us all to grow financial markets — massively. Once that identification and grading (i.e., standardization) is complete, we can begin to price the risks openly, out of a more complete understanding of the likely incidence of each defined peril. The full disclosure across a product's life cycle, induced by incentives that reduce costs or increase market advantage, provides the financial system with a stronger foundation.

Moving Forward, Mitigating Risk

In hindsight, it is now clear that we have built our entire financial system on services related to the intermediation of credit risk. We now have no choice but to recognize that the ultimate costs of all credit risk transfers, without regard to whether or not they occur in consumer or corporate or government debt, is actually a single risk that aligned to create a financially cataclysmic event that has cost the nation many trillions of dollars of value. The common "egg" in all baskets is credit. But the Marketcore system not only differentiates credit, it also works for risks that do not presently correlate to credit.

Most appropriately, the proposed solution facilitates risk management and increases operating efficiencies; thereby reducing costs, which typically builds business volumes. Today, we know that single elements of risk can combine in complex ways that can overwhelm the marketplace. This requires us to look at each of the risk elements and the full variety of combinations in order to detect and, at least in some cases, predict risk. Only then is risk limitation and mitigation possible.

The Marketcore solution is focused on eliminating the pitfalls in the market structure and methodologies that contributed to this debacle. It replaces them with a structure that generates a more productive, fully functioning financial marketplace. Such a result is

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entirely achievable with a modicum of adjustment in how we do business, combined with prompt action on the part of industry leaders.

Conclusion

In our work, investment and disclosure functions have been united to assure a standard of risk prediction and management that can re-invent the marketplace. Using it, we can start to dispel forever the devil in the details that currently has overwhelmed market and informational efficiency. In this new business process, we can differentiate risks to create new markets and new products.

The time to restore confidence in market functions is immediate. All that is required is a logical business process that clearly links investment and disclosure and the common will to execute the process. Its implementation has the possibility of being a paradigm shift, but properly managed it is simply the adoption of more rigorous business process and methodology using available technology.

We can work together to rebuild finance. At a time of great crisis, when cynicism and resignation are rampant, self-regulating industry groups and government oversight need to be greater than any "special interest." We can join together to re-tool our business process and rebuild confidence using the transformational benefits of hybrid products that address and fund the very largest of policy issues facing the planet. The choice is clear. It is up to you. ■

Reference

1. Wikipedia describes information asymmetry models as follows: "Information asymmetry models assume that at least one party to a transaction has relevant information whereas the other(s) do not. Some asymmetric information models can also be used in situations where at least one party can enforce, or effectively retaliate for breaches of, certain parts of an agreement whereas the other(s) cannot ... In adverse selection models, the ignorant party lacks information while negotiating an agreed understanding of or contract to the transaction, whereas in moral hazard the ignorant party lacks information about performance of the agreed-upon transaction or lacks the ability to retaliate for a breach of the agreement. An example of adverse selection is when people who are high risk are more likely to buy insurance, because the insurance company cannot effectively discriminate against them, usually due to lack of information about the particular individual's risk but also sometimes by force of law or other constraints. An example of moral hazard is when people are more likely to behave recklessly after becoming insured, either because the insurer cannot observe this behavior or cannot effectively retaliate against it, for example by failing to renew the insurance." <http://en.wikipedia.org/wiki/Information_asymmetry>

Regulatory and Legislative Interest Group Committee

Mission Statement

In a regulated industry where "compliance matters," we provide information and insight on the laws and regulations affecting the business of insurance. We promote healthy discussion and dialog on the rapidly evolving federal and state regulatory insurance arena.

Vision

The Regulatory and Legislative Interest Group strives:

- To be the first place Society members choose to learn about proposed or recently enacted insurance laws and regulations.
- To be recognized within the Society as one of the premier interest groups.
- To provide relevant regulatory information about all countries, including those that may impact United States marketplaces.
- To be a trusted source of information about the various United States insurance markets.
- To provide a forum for discussion on pertinent regulatory or legislative issues.

Will a New Insurance Exchange Improve Insurance Markets?

by Aaron Brandenburg, ARM

Aaron Brandenburg, ARM, is an economist and statistical information manager with the National Association of Insurance Commissioners and has been with the organization for five years. He conducts econometric and statistical research for the NAIC and its members on a wide range of issues. His work has involved diverse insurance issues including catastrophic risk, rate regulation and the economics of insurance. Prior to joining the NAIC, Brandenburg was an economic analyst with Shook, Hardy and Bacon, where he was responsible for the development of economic and econometric experts, the drafting of regulatory submissions and general analysis of market and economic issues. He is currently working toward his CPCU designation.

Recently, the term "insurance exchange" has worked its way into the mainstream lexicon as the federal government considers instituting an insurance exchange as part of its efforts to address health insurance reforms. The details on this exchange remain preliminary and undefined, but it is important to note that, outside of the health world, an insurance exchange is actually close to being up and running.

The Council of Insurance Agents and Brokers, which represents commercial insurance brokers and agents worldwide, has partnered with LexisNexis Risk Solutions and FirstBest Systems Inc. in developing a Web-based insurance exchange for agents and brokers. The exchange will employ intellectual property developed by Marketcore Inc. The exchange, initially open to mid- and large-market commercial property-casualty lines, will give agents and brokers access to a single system where they can submit insurance applications in an attempt to fill business for their customers.

The exchange will allow agents and brokers to submit insurance applications in a single step, real-time process. Agents will be able to see the availability, price and coverage differences in insurance products from a variety of insurance carriers. Currently, brokers have to interact with separate carriers in different systems, creating a very inefficient and time-consuming process. Attempts at building a similar insurance exchange were never seen to fruition, but advancements in technology helped make this current version a reality.

The existence of an exchange should provide numerous benefits to the workings of insurance markets. The movement away from separate systems to a single system will reduce redundant work for insurance agents and brokers. This will free up time for brokers to place more business or spend additional time on each customer's needs. Because brokers will enter all data at once and send submissions to multiple carriers, brokers will be able to provide more competitive quotes to their customers — and more quickly than ever before.

The ability to see insurance product availability, coverage and pricing differences will allow the broker to place the coverage in a manner that best suits the customer. This helps the customer by providing a broader choice of insurance products and access to additional carriers of all sizes and types. In addition, smaller customers will be aided as brokers will have additional resources and an easier way to place small business with the broad array of options within the exchange.

New markets will be open to numerous participants, both at the broker and customer levels. Carriers will benefit by being exposed to more customers, while brokers and their customers will benefit by being exposed to more carriers and products. Increased competition may lead to a fall in prices. Carriers will be able to more easily differentiate their products by offering innovations, tailoring to customers' needs or offering better pricing.

In today's financial climate, there is a widespread call for greater transparency within markets. This exchange will provide a real-time, comprehensive marketplace where transactions will be much more transparent. Brokers and other observers will be able to track trends in the marketplace as they happen, allowing them to have greater and more timely knowledge of new products, changes in terms and conditions, and movements in pricing.

The pilot program for mid- and large-market commercial lines is scheduled to begin in the fall of 2010, with full production set for early 2011. The exchange will initially focus on commercial lines, but it is expected to eventually cover all sizes and lines of property-casualty risks.

It is likely that there will be numerous benefits that arise from this new insurance exchange, primarily in terms of providing more efficient and transparent markets to the insurance industry. It will be interesting as we move forward to monitor the extent to which these benefits are realized and if lessons can be learned for instituting insurance exchanges, such as for health insurance, in the future. ■

New York Working to Re-Establish the New York Insurance Exchange

by Stewart A. Keir, CPCU, CFE, and Robert A. Romano, J.D.

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The New York Insurance Exchange ("Exchange") may be back. The idea of re-establishing the Exchange has the strong support of Governor Paterson, Mayor Bloomberg and a number of legislators in Washington, D.C., and Albany, N.Y. In addition, New York Superintendent **James J. Wrynn** has now formed a Working Group (the "Working Group") to study how best to rebuild the Exchange.

The original Exchange, created by statute in 1978, was an attempt to emulate Lloyd's of London ("Lloyd's") and capture some of the business that was being placed overseas and offshore. The concept was to create a marketplace in New York, the financial services capital of the U.S., for reinsurance and more complex risks that were, for a number of reasons, being placed outside of the U.S. During the same period, Illinois and Florida also opened their own insurance

exchanges. For a number of reasons, none of these operations were successful.

The New York statute that created the original Exchange remains on the books and allows underwriting syndicates to write several types of business:

- Reinsurance of all kinds, including life reinsurance.
- Non-U.S. direct business.
- Surplus lines insurance in other states.
- New York risks rejected by the New York Free Trade Zone, which permits a New York licensed property-casualty insurer to write insurance exempt from the normal New York rate and form filing requirements on certain unusual or high-loss hazard or difficult-to-place risks.

This legislation is broad enough to permit the creation of a new Exchange but may need revision or new regulations to meet the needs of today's markets and to avoid the challenges that the first Exchange faced.

To start this endeavor, Superintendent Wrynn invited a number of interested parties, including **Stewart A. Keir, CPCU, CFE,** our Locke Lord colleague and former chief of the New York Insurance Department Insurance Exchange and Excess Line Bureau, to participate in the Working Group. The Working Group met with the Superintendent on Jan. 21, 2010, and is scheduled to have a number of additional meetings over the coming months with the goal of having a final proposal for action in or about September 2010.

The Superintendent indicated the Exchange:

- Must benefit the insurance industry.
- Should have a New York City situs and backoffice operations upstate.
- Should seek to be rated by a recognized rating agency.
- Should have an advanced technology platform, standardized forms, contract certainty and expeditious claims handling.
- Should work with and complement Lloyd's.

Sub-groups will be established to work on specific areas:

- Regulatory oversight.
- Capitalization.
- Tax.
- Operations and technology.
- Multistate issues.
- Markets.
- Government relations.

If all proceeds on time and the results are favorable, the Superintendent would like the new Exchange to be up and running by 2011. Our firm will be following developments closely and participating in this process. If any of our clients or friends have questions or wish to raise issues, they are invited to give the authors a call. ■

Title Insurance Industry Constantly Battles Cyclical Market

by Jeremy Yohe

Jeremy Yohe is director of communications for the American Land Title Association. He has more than 15 years' experience in the journalism field, and has written about title insurance for several years. He can be reached at (202) 261-2938 or by e-mail at jyohe@alta.org. Visit ALTA online at www.alta.org for news and resources for the title industry.

Profits Earned during Boom Years Must Be Reserved To Cover Claims during Down Times

The profitability of the title insurance industry always has been and always will be contingent on the cyclical nature of the mortgage market. The latest economic downturn, which started in late 2006 with the crash of the subprime mortgage market, greatly impacted the industry's revenue while forcing many companies to close operations.

During the housing bubble in the first half of the decade, the title insurance industry's revenue more than doubled. As the number of mortgage transactions drove up title insurance revenue — along with a greater incidence of title claims — the housing market downturn resulted in a significant paring back of revenue and margins in 2008. The upward trend in the rate of defaults and foreclosures spread to other areas of the mortgage market in the form of greater delinquencies and rates of foreclosures in the "Alt-A" and even "prime" mortgage segments, which continue to hamper the market.

As the market soured and origination volume plummeted, margins were squeezed and claims increased. While this is the natural business cycle of the title insurance industry, companies continue to evaluate and manage their cost structure and make appropriate adjustments where economic conditions dictate. This continual focus helps the industry better maintain operating margins even during the deepest recessions.

The Down Cycle

The fallout caused title insurance premiums to deteriorate substantially over the past few years, causing industry revenue to decrease. In 2008 alone, the industry posted an operating loss of $711 million, resulting in the largest reduction in total operating revenue (almost 26 percent) in 40 years. Premiums written stood at nearly $17 billion in 2005, but were sliced to around $10 billion in 2008 and fell to $9.6 billion in 2009. While the industry has seen declines from 2007 to 2009, the market remains large and grew significantly from 1995 until 2005.

Operating income for the entire U.S. title insurance industry grew from $4.8 billion in 1995 to $17.8 billion in 2005 and then decreased to $17.6 billion in 2006, to $15.2 billion in 2007and to $11.3 billion in 2008. Growth in the industry is closely tied to various macroeconomic factors, including, but not limited to, growth in the gross domestic product, inflation, unemployment, availability of credit, consumer confidence, interest rates and sales of and prices for new and existing homes, as well as the volume of refinancing of previously issued mortgages.

A low interest rate environment, coupled with government incentives to refinance mortgages, significantly increased total mortgage originations during 2009. The resulting title revenue growth, coupled with reduced expenses after years of cost-cutting initiatives, returned the industry to profitability and stronger margins.

The four largest national title insurance underwriter families, which account for greater than 90 percent of total industry revenue, reported an underwriting profit for 2009 for the first time in several years. Spurred by heavy mortgage refinancing activity, title operating revenue for this group increased by greater than 16 percent in 2009 compared with 2008. Operating margins for these four companies improved from minus 4.7 percent in 2008 to 3.9 percent in 2009.

The slight improvements experienced last year could be short lived, however, as the Mortgage Bankers Association (MBA) expects a substantial decline in mortgage originations for 2010 due largely to an anticipated decline in refinancing activity. Mortgage origination volume is expected to be around $1.3 trillion in 2010, $1.2 trillion in 2011 and $1.4 trillion in 2012. The mortgage market generated more than $3 trillion in originations five years ago.

The scheduled end of the federal government's homebuyer tax credit on April 30, 2010, combined with the likelihood of rising mortgage rates throughout the year, will hurt the refinancing piece of mortgage originations in 2010.

Additional key factors that will influence the level of mortgage originations and title insurer revenue going forward include the robustness of the economic recovery and its impact on housing sales, interest rate movements and changes in bank mortgage lending practices. MBA forecasts a 61 percent retreat in refinancings, from $1.4 trillion in 2009 to $529 billion in 2010, while purchase activity is expected to be relatively flat at $745 billion in 2010.

This 40 percent decline in originations is more severe than the approximately 25 percent decrease between 2007 and 2008. Under these conditions, expense management remains a key concern for title companies, which cut headcount and operating expenses considerably in the last two years, and are better prepared for a less favorable market environment.

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Title Insurance Industry Constantly Battles Cyclical Market

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However, further expense reductions would likely be in order for the title market to turn a near-term profit if a further significant drop in mortgage market activity materializes. Fitch Ratings estimates that if there is a 10 to 15 percent decline in title operating revenue during 2010, the four largest national underwriters would have to cut noncommission operating expenses by 5 percent to reach break-even underwriting results.

While the industry posted significant losses in 2008, companies that controlled costs aggressively returned to profitability in 2009 and have positioned themselves for continued success in 2010 and beyond. Despite the economic downturn, the title insurance industry remains well capitalized and will continue to play a critical role in the U.S. economy by insuring the safe and secure transfer of real estate and facilitating growth of the secondary market. Through the third quarter of 2009, the title insurance industry had admitted assets of over $8.6 billion, including over $7.4 billion in cash and invested assets. Also, statutory reserves were almost $5 billion and statutory surplus exceeded $2.3 billion.

Loss Experience in the Title Industry

There are many factors that impact claims. The recent claims emergence has resulted from decreases in real estate prices, increases in defaults and foreclosures, and the higher-than-expected claims emergence from lenders policies. The current economic environment appears to have more potential for volatility than usual over the short term, particularly in regard to real estate prices and mortgage defaults, which directly affect title claims. Loss experience in 2008 and 2007 deteriorated noticeably, as the spike in defaults and foreclosures netted more claims. Claims have risen steadily over the past 10 years. In 2005, the industry paid $748 million in claims, but paid out $1.07 billion in claims in 2008. Numbers have not been compiled for 2010, but the industry paid $667 million in claims through the third quarter.

The volume and timing of title insurance claims are subject to cyclical influences from real estate and mortgage markets. Title policies issued to lenders are a large portion of the industry's volume. These polices insure lenders against losses on mortgage loans due to title defects in the collateral property. Even if an underlying title defect exists that could result in a claim, often the lender must realize an actual loss, or at least be likely to realize an actual loss, for title insurance liability to exist. As a result, title insurance claims exposure is sensitive to lenders' losses on mortgage loans, and is affected in turn by external factors that affect mortgage loan losses.

A general decline in real estate prices can expose lenders to greater risk of losses on mortgage loans, as loan-to-value ratios increase and defaults and foreclosures increase. The current environment may continue to have increased potential for claims on lenders' title policies, particularly if defaults and foreclosures are at elevated levels. Title insurance claims exposure for a given policy year is also affected by the quality of mortgage loan underwriting during the corresponding origination year. The sensitivity of claims to external conditions in real estate and mortgage markets is an inherent feature of title insurance's business economics that applies broadly to the title insurance industry. Lenders have been experiencing higher losses on mortgage loans from prior years, including loans that were originated during the past several years. These losses have led to higher title insurance claims on lenders policies, and also have accelerated the reporting of claims that would have been realized later under more normal conditions.

Title insurance policies have no set termination date and no limitation on filing claims. However, the only fees collected are the one-time charges when the policy was issued. Losses reported in any one year will affect that year's profitability. Most title losses are reported and paid within five to seven years after policy issuance. However, the tail for title policy claims is at least 20 years.

Loss Preventive Nature of Title Industry

During periods of reduced premium volume, a title company's profit margin depends on its ability to manage the cycle by reducing expenses. General expenses incurred as part of the title-search process typically make up 85 percent or more of premium volume, reflecting the loss prevention nature of title insurance (according to A.M. Best Co.).

Since title insurance typically involves the acceptance of prior transaction-related risk rather than future risk, the underwriting process in the title insurance industry differs significantly from the typical property-casualty underwriting process. The title underwriting process is designed to limit risk exposure through a thorough search of the recording documents affecting a particular property. The insurance component of a title product only indemnifies for existing — but identified or specifically underwritten — defects in the condition of a property's title. Unlike property and casualty, title insurance does not respond to future occurrences but only to past defects that were in place at the time the property was sold.

Operating expenses are the largest component of a title company's costs. A title company's ability to expand its infrastructure and maximize operating profits in good market conditions, and to contract and control costs in poor market conditions, is critical to its long-term success and solvency. Because of title insurers' dependency on the health of the mortgage market and favorable interest rates, title industry revenues and profitability are susceptible to volatility. To dampen the volatility, the industry has improved its technology and workflow process.

Since infrastructures of personnel and title plants must be maintained to provide title services, a title company's profitability is highly sensitive to mortgage transactions. It is as difficult for a company to reduce its costs of doing business in the face of a downturn in mortgage origination activity as it is to reacquire trained staff when volume returns. Surplus plays a critical role by providing a cushion that permits a title insurer to ride out poor real estate markets, since not all of its costs are variable and able to be reduced.

The downturn has significantly altered the competitive landscape of the title insurance industry. At the underwriter level, there were more than 100 underwriters serving the industry. Now, that number is down to less than 75 brands. Industry consolidation began with the notable bankruptcy of LandAmerica Financial Group at the end of 2008. Leading up to the holding company's problems, LandAmerica, which at the time captured about 18 percent of the market, had already merged two smaller underwriters into larger ones within the group. After the bankruptcy, Fidelity National Financial bought the remaining title underwriters and became the largest title insurance group in the country with about a 45 percent market share.

Looking Ahead

Since 2008, the federal government has played an active role in the mortgage market through the federal housing authority and the two government-sponsored entities Fannie Mae and Freddie Mac. These actions helped stabilize the mortgage market and cushioned the fall in transaction volumes. Recent tax legislation such as the first-time homebuyer tax credit of 2008-09, which was extended through June 2010 for first-time buyers and included certain existing homeowners, also helped bring more buyers into the market and modestly rejuvenated a dilapidated housing market. While significant foreclosure activity remains a drag on overall housing prices, the incentives have benefited the title industry to some extent in 2009.

The mortgage market for the remainder of 2010 is expected to remain weak, with little improvement in 2011. The title insurance industry may see lenders begin to offer more jumbo loans in 2010, but it is doubtful lenders will sway from their retail-focused distribution channel. Since the market downturn, the origination channel has morphed significantly. In 2006, brokers accounted for about 70 percent of all loans. Now, lenders continue to push as much business as possible through retail offices. *Inside Mortgage Finance's* quarterly survey reported mortgage broker share of originations fell to a record low of just 12 percent in third-quarter 2009. Retail, meanwhile, climbed to 51 percent. This has forced the title insurance industry to market to correspondent lenders such as smaller banks and credit unions, who are likely to be a major force in mortgage lending in 2010. In the coming year, the bulk of loans will continue to be GSE-, FHA- and VA-type products. There won't be another wave of "exotic" loans emerging anytime soon.

The lessons of nonprime lending are fresh in everybody's minds. The loose lending underwriting of the mid-2000s propped up an exhausted market and only exacerbated the current downturn. Recovery in the non-agency mortgage space will have to come from plain vanilla, very safe mortgages — like conservatively underwritten jumbo loans made to very prime borrowers. The mortgage market will have to prove to investors and the rest of the world that it knows how to make profitable and safe mortgages — without the benefit of government guarantees — before it can even consider more exotic products. Until the mortgage market can achieve a sustained recovery, the title insurance industry will continue to operate on slim margins. Having survived many other cycles over the past century, this is a reality the title insurance industry already knows. It has, and always will, provide assurance in the safe and secure transfer or property. ■

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