Mortgage Crisis Lessons Apply To Property & Casualty Industry

By Bob Fenner

The unprecedented mortgage crisis that helped fling our nation's economy into its most desperate state in decades has taught us all some very hard lessons, or maybe reminded us of important principles that we have neglected.

While there are multiple reasons and complex issues, the fundamental rules are now clearer than ever before. For borrowers, don't take out a loan you aren't able to pay back. For lenders, don't lend money to people who won't be able to pay you back.

A similar concept exists in the property-casualty insurance industry. There are underwriters in most facets of the financial sector. Literally, to underwrite means "to write underneath, sign, subscribe." In property and casualty insurance and risk management, it means more.

According to the IRMI Glossary of Insurance and Risk Management, underwriting means "the process of determining whether to accept a risk and, if so, what amount of insurance the company will write on the acceptable risk, and at what rate. Underwriters are companies, individuals, or insurance companies who carry on this critical activity for their own account or for that of others." This is the context in which the term underwriting is used here.

Sometimes insurance companies forsake time-honored underwriting principles to increase the volume of premium they write, much like what happened in the mortgage industry. When an insurance company issues a policy, it has increased its risk. Too much risk and too little premium and you have a problem. Doesn't that sound familiar?

Subsidizing Underwriting Losses

In recent years, when equity markets were soaring and many companies (especially financial institutions) were paying high dividends (remember?), property and casualty insurance companies were able to offset underwriting losses with investment gains. The investment gains were big enough to cover a multitude of underwriting sins.

It is difficult now to identify any safe, liquid investment for insurance companies to use to subsidize underwriting losses. And there have been losses. Take the crazy weather Central Ohio has experienced in the last few years. In 2008, Ohio became a coastal state with the arrival of Hurricane Ike. This year, the rain and winds of Feb. 12 left a mark. And now it seems Franklin County is in the heart of the "hail belt." While these are just intermittent instances of property losses, the cumulative effect adds up quickly.

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People and businesses get more litigious in difficult times like these, perhaps rightly so. Was it negligence or malfeasance that turned our 401(k)s into 201(k)s? Directors and officers liability, professional liability and employee dishonesty policies are going to take big hits if they haven't already. More product liability claims can probably be expected, too.

Throw in anticipated higher inflation, and all of these claims are going to get more expensive to settle. As claims costs mount against income, some insurance companies and some adjusters—unfortunately—will resist paying certain claims that they might have paid quickly and fairly before. This is not the right way to manage risk.

The right way to manage risk hinges on responsible underwriting. It needs to be practiced both by insurance companies and insurance buyers. Insurers need to charge adequate premium for risk so that they remain financially solid and are able to pay claims and maintain customers' confidence.

Do Some Research

Insurance buyers need to underwrite the companies and brokers they do business with. So it makes sense to do a little homework before signing on the dotted line. How long has the company been in business? What kind of reputation do they have? Does the insurance company make money with careful underwriting and fair claims payments, or by lowball pricing, loose underwriting and less-than-fair claims practices?

Failure of underwriting discipline can lead to worse outcomes than poor claims handling and payment. It is the major contributing factor in insurance company insolvencies, which put additional burdens on our society.

What if eight or 12 years ago, more concern had been voiced over lax to nonexistent mortgage application and granting procedures? What if the financial industry and the U.S. government had paid attention to those concerns? Real estate prices might not have escalated as much as they did, and the foreclosure crisis might not have occurred. Because an ounce of prevention is worth a pound of cure, all financial transactions—particularly property and casualty insurance—should be carefully researched and analyzed.

When talking about insurance, a concept that always comes up is "peace of mind." This is easily achieved by combining well-placed trust and confidence with careful underwriting. ◊

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