Lessons from the Credit Crisis

By Chris Burand

Securitization of debt, where the assets (loans) on banks' balance sheets are bundled up and then pieces are sold to buyers in the form of bonds and derivatives, is a great financial innovation for freeing up capital and thereby, the supply of capital. This in turn, decreases the cost of consumer credit. The credit crises though should be a stark reminder that too much of a good thing can be poisonous.

Underwriting

Several excellent studies have shown that a key cause of so many loan defaults has nothing to do with the economy or with the people taking out the loans. The weak link is underwriting. Traditionally, the bank that makes the loan, keeps the loan on their own books which gives them a lot of incentive to underwrite their loans very well. By severing the link between those writing the loan and those keeping the loans, the originators lost all incentive to underwrite. They were no longer held accountable. They had already made their money.

The investment bankers, investors, and bettors then added fuel to the growing fire by making a very big mistake that is almost impossible to fathom given their computer models and the fact that we are dealing with huge companies that should be totally rational and logical. They believed that because they did not get burned immediately by taking large risks, they were perfectly safe to double down.

In the insurance world, this is very similar to believing you are a perfect underwriter after one week of writing risks without a single claim! Insurance carriers are still, after decades, forgetting that losses trail premiums. But in time, the losses do catch up.

The link between underwriting and results may not have been totally severed in the insurance industry, but it is wearing thin as companies have made more money in 2006 and 2007 than possibly in the entire history of the industry. As a result, many insurance company CEOs believe they are invincible underwriters. But the fact is, the developed world has undergone some very interesting demographic and workplace environment changes that have resulted in a significant decline in claims frequency and while severity has increased, the increase has not offset the decrease in frequency. This trend has generated considerable profits for agents and companies.

The industry's extra profitability then has very little to do with insurance company underwriting genius, so even though bad underwriting is occurring today and underwriting results have not deteriorated significantly yet, the industry cannot not continue to practice lax underwriting.

Finance 101 shows how leverage works if operating profits exist and if operating profits evaporate, leverage will always cause an almost immediate crash. The credit crisis was, in many ways, very basic finance. The same goes for underwriting. As long as the economy is doing well, claims will lag slightly. When the economy slows significantly, as it is, claims will get ahead of premium growth.

Knowledge & Transparency
Many investors did not understand the securities they were buying. They were supposed to be sophisticated buyers but the fact is, virtually all the people participating in that market did not understand the instruments they were trading and adding to the complexity, the system lacked transparency.

Some of the insurance industry's slot rating computer models remind me of this situation. Some of these models are clearly superior. However, very few company people can explain their own models. Making the situation worse, many of the slot rating programs lack transparency and when company people and agency personnel do not understand and cannot explain the logic behind these systems, problems are sure to follow

When transparency is lacking, distrust grows. If an agency employee does not understand and cannot explain why a client's rate is particularly high, the employee will likely (either subconsciously or directly) communicate his or her distrust of the company's rating process to the client. Distrust will immediately build in the customer's mind and this adds to the industry's already tarnished image. Distrust is a huge and growing issue for this industry.

Securitization of risk is not a bad thing. The concept is good and economies worldwide can gain from the securitization of financial instruments. The problem was the execution. First, the parties involved failed to maintain accountability throughout the system. Second, they believed that if nothing immediately bad happened, then all their decisions must have been correct. They kept building more and more additions on a foundation of cards and since nothing bad had happened yet, they really believed that the foundation was rock solid. Third, the players did not really even understand what they were using for building blocks.

The insurance industry has a long history of repeatedly making similar mistakes. This industry need not repeat these mistakes again if insurance companies act quickly to maintain underwriting accountability at every step, if they will reemphasize and reeducate everyone, from top to bottom, on the time lag between writing business and incurring losses, and if they will ensure that everyone completely understands their rating tools.

Chris Burand is president of Burand & Associates, LLC, an insurance agency consulting firm. Readers may contact Chris at (719) 485-3868 or by e-mail at **chris@burand-associates.com**.

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