

THE IMPACT OF THE FINANCIAL CRISIS AND THE GLOBAL ECONOMIC DOWNTURN
ON THE PROPERTY & CASUALTY INSURANCE INDUSTRY
AS IT PERTAINS TO THE PUBLIC INSURANCE ADJUSTING PROFESSION

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Introduction

The financial crisis that exploded between 2007 and 2008 has shaken up the foundations of the existing financial systems across the world. The speed and magnitude of the meltdown has been shocking. What had started as a deflation of the housing bubble quickly became a severe liquidity crisis crippling the financial markets. Within the span of a single month, nine of the largest, oldest, and most venerable U.S. financial institutions collapsed and were either sold or placed in conservatorship with the federal government, disappearing from the financial market scene forever. Financial contagion spread immediately, and a similar fate was suffered by institutions all around the world. Trillions of household net worth and commercial capital vanished, leaving behind confusion, fear, and uncertainty.

This essay will consider the specific impact of the current economic environment on the public insurance adjusting profession. To this end, Part I will present a simplified description of the origins and nature of the financial crisis. Part II will demonstrate that, contrary to expectations, neither the economic impact on the property & casualty industry nor the regulatory backlash against the industry are likely to significantly impact insurers. In this context, Part III will then list a number of possible developments that may affect the public insurance adjusting profession.

I. 2007 Financial Crisis: The Background

The 2007 financial crisis erupted when systemic risks within the global financial systems were exposed by the bursting of the U.S. housing bubble. The following is a simplified overview of the developments that precipitated the crisis.

A confluence of several factors contributed to the inflation of the housing bubble in the U.S. First, the explosion of the dot-com bubble in 2000, exacerbated by the 2001 terrorist attacks on the World Trade Center, prompted the Federal Reserve to adopt a policy of cutting short-term interest rates in an attempt to prop up the faltering stock market and to prevent a recession.¹ Second, decades of federal government's promotion of homeownership,² combined with low interest rates which made housing affordable for more people, culminated in an unprecedented rise in demand for real estate and, consequently, price inflation.³ Third, the 2000 stock market crash caused by the bursting of the dot-com bubble left investors with a distaste for stocks and created a demand for alternative investment opportunities. Because real estate was perceived as a safer investment than stocks, and provided attractive returns, funds began to flow into the real estate market, further increasing demand for real estate and causing prices to rise even higher. In no time, tremendous increases in real estate prices generated by the confluence of low interest rates, federal homeownership policies, and the flight of money out of the stock market, fueled a speculative frenzy in the real estate market.⁴

Institutional investors, for whom it would be impractical to purchase individual houses or mortgages, took advantage of the booming real estate market through mortgage securitization. Lenders sold the right to receive mortgage payments (or foreclosure proceeds in the event of

¹ See Fed. Reserve Bd., Open Market Operations, <http://www.federalreserve.gov/fomc/fundsrate.htm> (last visited Apr. 23, 2009).

² See, e.g., Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085; Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788; Federal Home Loan Mortgage Corporation Act, 12 U.S.C. § 1451 (2006); Community Reinvestment Act, 12 U.S.C. §§ 2901-06 (2006). See generally A. Mechele Dickerson, *The Myth of Home Ownership and Why Home Ownership Is Not Always a Good Thing*, 84 IND. L.J. 189 (2009).

³ Between 1996 and 2006, average home prices in the U.S. increased by 175%. See U.S. CENSUS BUREAU, MEDIAN AND AVERAGE SALES PRICES OF NEW HOMES SOLD IN UNITED STATES (Feb. 2009).

⁴ Nearly 40% of all home purchases in 2005 were investment properties or secondary residences. Noelle Knox, *Second homes 40 percent of market*, CHI. SUN TIMES, Apr. 23, 2006, at E4.

default) to investment banks, which combined mortgages into large pools, and in turn sold bond-like securities collateralized by the value of the pooled mortgages.⁵ Investors purchasing such securities paid a single large sum in exchange for the right to receive a stream of payments, with interest, over a period of time; the stream of payments came from mortgage payments received from individual borrowers. Additionally, securities based on payments from the same mortgage pool were structured into several classes, or “tranches”, with riskier, subordinated tranches receiving higher interest in exchange for being first in line to assume losses from defaults within the pool.⁶ This permitted the senior tranches to receive high credit ratings, because they would continue to receive payments even if a number of mortgagees within the pool defaulted. However, ratings were based on the structure of tranches within the pool, rather than on the quality of the underlying pool.⁷ Thus, credit rating agencies issued AAA (very low risk) ratings to senior tranches so long as there existed subordinated tranches that would absorb, for example, the first 20% of defaults within the pool – even though the *entire* pool might be composed of nothing but highly risky debt, and the entire pool, including the 80% backing up the AAA-rated securities, was likely to fail.

Furthermore, the riskiest tranches, which no one wanted to buy, were repackaged with other types of debt into highly complex securities (collateralized debt obligations, or CDOs) which were too poorly understood to be properly evaluated by either credit rating agencies or investors. But because these securities could be purchased in combination with credit default swaps, which operated as insurance against defaults on underlying mortgages, rating agencies

⁵ Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5, 33 (Mar. 2009).

⁶ *Id.* at 34.

⁷ *See generally*, U.S. SECURITIES & EXCHANGE COMM’N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF’S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES (July 2008).

and investors mistakenly believed them to be safe. However, unlike traditional insurers, issuers of credit default swaps were not required to maintain adequate capital reserves to cover expected “claims”.⁸ Issuers of credit default swaps did not maintain substantial reserves because as long as real estate prices continued to rise, homeowners could refinance their mortgages, take out home equity loans, or sell houses at a profit, and were not at risk of default. However, when the housing market cooled and these options were no longer available, foreclosures began to mount. Issuers of credit default swaps were unable to pay as promised and suffered heavy losses, and investors who had purchased CDOs saw their investments wiped out.

But, while the real estate market was booming, structured mortgage-backed securities became increasingly popular because they were perceived to provide high returns and carry low risk. The demand by investors for such products fueled the demand for new borrowers,⁹ and once the supply of high-quality mortgages was exhausted, lenders started issuing large numbers of subprime mortgages.¹⁰ Because lenders immediately sold most mortgages for securitization, lenders no longer had exposure to risk of default by the borrower and therefore lost the incentive

⁸ See Thomas Lee Hazen, *Filling a Regulatory Gap: Is It Time to Regulate Over-the-Counter Derivatives*, 13 N.C. BANKING INST. 123 (2009) (discussing problems arising from failure to regulate credit default swaps as either insurance or securities). Although in 2004 New York amended its insurance law to exclude credit default swaps, N.Y. Ins. Law § 6901(j-1) (2005), in Sept. 2008 New York governor announced plans to regulate some credit default swaps as insurance (plans suspended due to federal regulatory activity). See Press Release, Governor Paterson Announces Plan to Limit Harm to Markets from Damaging Speculation (Sept. 22, 2008), available at <http://www.ins.state.ny.us/press/2008/p0809224.pdf>.

⁹ *The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 2-3 (2008) (statement of Dr. Alan Greenspan, former Chairman, Federal Reserve Board of Governors).

¹⁰ The subprime mortgage loan market exploded from \$65 billion in 1995 to \$665 billion in 2005, with the value of corresponding mortgage-backed securities growing from \$18 billion to \$508 billion. *The Housing Decline: The Extent of the Problem and Potential Remedies: Hearing Before the S. Comm. on Fin.*, 110th Cong. 3 (2007) (statement of Michael Decker, Senior Managing Director, SIFMA) (citing INSIDE MORTGAGE FINANCE PUBLICATIONS, THE 2006 MORTGAGE MARKET STATISTICAL ANNUAL, vol 1, at 209-222).

to perform quality underwriting.¹¹ Mortgages were issued to high-risk borrowers without regard for their ability to repay.¹²

In 2007, the real estate prices began to fall due to oversupply of houses. Borrowers could no longer rely on rising home values to finance mortgage payments with home equity loans, and to refinance adjustable-rate mortgages in order to avoid interest rate (and mortgage payment) increases. Speculative real estate investment also came to a halt, further depressing prices. As housing sales slowed down, speculators who had expected to sell their properties quickly were trapped into having to make mortgage payments that they had not budgeted for. Falling house prices exposed the inability of borrowers to pay, triggering a wave of foreclosures. Losses of mortgage payments on foreclosed properties immediately materialized as losses to investors in structured mortgage-backed securities. Compounding the problem, many mortgages and home equity loans had been issued for the amount of house prices at the peak of the boom. Once prices fell, the amount owed on such mortgages exceeded the value of the underlying property. These reductions in the value of the collateral exacerbated losses suffered by investors. Furthermore, losses associated with credit default swaps far exceeded actual losses associated with foreclosures, because credit default swaps were sold not only as insurance for investment products, but also in large numbers as purely speculative bets on Wall Street.¹³

¹¹ *The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 3 (2008) (statement of Christopher Cox, Chairman, U.S. Securities & Exchange Commission).

¹² *Id.*

¹³ The credit default swaps market peaked at \$62 trillion at the end of 2007, and was \$39 trillion at the end of 2008. Katrina Nicholas & Abigail Moses, *Credit Swaps Market Cut to \$38 Trillion, ISDA Says*, BLOOMBERG NEWS, Apr. 22, 2009. In contrast, the corresponding values of the securitized home mortgages were \$6.3 trillion and \$6.6 trillion. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FEDERAL RESERVE STATISTICAL RELEASE Z.1: FLOW OF FUNDS ACCOUNTS OF THE U.S. 94 (Mar. 12, 2009).

In June 2007, two hedge funds operated by Bear Stearns, a major investment bank, were revealed to have suffered heavy losses associated with investments in structured mortgage-backed securities.¹⁴ Because hedge funds borrow heavily from other financial institutions to finance their investments and are not required to disclose the sources of their funds or their investments, the failure of the Bear Stearns hedge funds signaled that any financial institution could find itself exposed to heavy losses from dealing with numerous hedge funds.¹⁵ Due to the complexity of structured mortgage-backed securities and derivatives, investors were not even able to evaluate their own exposure, much less assess creditworthiness of their trading partners. By September 2007, the uncertainty over who had exposure to what magnitude of subprime mortgage-related losses produced a liquidity crisis, whereby firms became unwilling to lend to each other,¹⁶ and many faced insolvency as a result.

During 2008, a number of large financial institutions in the U.S. and abroad succumbed to the credit crunch. In March 2008, Bear Stearns suffered a liquidity crisis and within days was sold to J.P. Morgan Chase for a fraction of its value.¹⁷ In July 2008, IndyMac, a large savings & loan institution, failed due to a bank run and was seized and placed into conservatorship with FDIC.¹⁸ In September 2008, the same fate befell mortgage finance giants Fannie Mae and Freddie Mac;¹⁹ Lehman Brothers, a major investment bank, was denied federal assistance and

¹⁴ Vikas Bajaj & Julie Creswell, *Mortgages Give Wall St. New Worries*, N.Y. TIMES, June 19, 2007, at C1.

¹⁵ DARRYL E. GETTER ET AL., FINANCIAL CRISIS? THE LIQUIDITY CRUNCH OF AUGUST 2007, CRS REPORT FOR CONGRESS, at 8 (Sept. 21, 2007).

¹⁶ Steven Rattner, *The Credit Crunch Continues*, WALL ST. J., Sept. 20, 2007, at A13; Vikas Bajaj & Mark Landler, *Mortgage Losses Echo in Europe and on Wall St.*, N.Y. TIMES, Aug. 10, 2007, at A1.

¹⁷ Andrew Ross Sorkin, *Saving Wall St. (For Now)*, N.Y. TIMES, Mar. 18, 2008, at C1.

¹⁸ Louise Story, *Regulators Seize IndyMac After a Run on the Bank*, N.Y. TIMES, July 12, 2008, at C5.

¹⁹ Stephen Labaton & Edmund L. Andrews, *In Rescue to Stabilize Lending, U.S. Takes Over Mortgage Finance Titans*, N.Y. TIMES, Sept. 8, 2008, at A1.

declared bankruptcy;²⁰ another investment bank Merrill Lynch,²¹ the largest U.S. savings & loan institution Washington Mutual,²² and fourth largest U.S. bank Wachovia²³ were sold to competitors, and world's fifth largest insurer AIG was 80% nationalized.²⁴

As a result of financial turmoil, in 2008 alone, \$7 trillion of shareholder wealth were wiped out,²⁵ GDP growth showed severe contraction at -6.3% in the last quarter,²⁶ unemployment hit 7.2% and a record number of jobs were lost.²⁷ Banks worldwide have taken \$920 billion of writedowns and losses since the financial crisis unfolded,²⁸ and total worldwide losses resulting from the financial crisis are projected to reach \$4.1 trillion by the end of 2010.²⁹

II. Impact of the Crisis on the Property & Casualty Insurance Industry

A. Economic Impact: Lower Profits Due to Lower Investment Returns

The economic impact on the property & casualty insurance industry will likely be modest. Primarily, the financial crisis has affected specialized mortgage and other financial

²⁰ Deborah Solomon et al., *Ultimatum By Paulson Sparked Frantic End*, WALL ST. J., Sept. 15, 2008, at A1.

²¹ Matthew Karnitschnig et al., *Bank of America to Buy Merrill*, WALL ST. J., Sept. 15, 2008, at A1.

²² Robin Sidel et al., *WaMu is Seized, Sold Off to J.P. Morgan, in Largest Failure in U.S. Banking History*, WALL ST. J., Sept. 26, 2008, at A1.

²³ Eric Dash & Andrew Ross Sorkin, *Regulators Push for Sale of Wachovia*, N.Y. TIMES, Sept. 29, 2008, at A15.

²⁴ Edmund L. Andrews et al., *Fed in an \$85 Billion Rescue of an Insurer Near Failure*, N.Y. TIMES, Sept. 17, 2008, at A1.

²⁵ Vikas Bajaj, *Markets Limp Into 2009 After a Bruising Year*, N.Y. TIMES, Dec. 31, 2008, at 1.

²⁶ Press Release, Bureau of Econ. Analysis, U.S. Dept. of Com., Gross Domestic Product: Fourth Quarter 2008 (Final) 3 (Mar. 29, 2009), available at <http://www.bea.gov/newsreleases/national/gdp/2009/pdf/gdp408f.pdf>.

²⁷ Kelly Evans & Kris Maher, *Yearly Job Loss Worst Since 1945*, WALL ST. J., Jan. 10, 2009, at A1.

²⁸ Jody Shenn, *Banks Face \$400 Billion More in Losses, JPMorgan Says*, BLOOMBERG NEWS, Apr. 20, 2009.

²⁹ INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT 27 (April 2009).

guarantee insurers, which had a direct exposure to the subprime mortgage market and the structured mortgage-based securities market.³⁰ In addition, subprime-related litigation has produced a surge in claims within the Directors & Officers and Errors & Omissions lines;³¹ and Employment Practices Liability and Workers Compensation are expected to see an increase in claims as well.³² However, these segments constitute a relatively small part of the industry.

With the exception of the lines of business directly exposed to the fallout of the subprime mortgage crisis, the primary economic impact on the industry will be in form of lower profits due to lower investment income. Investment income will suffer from capital losses on equity investments and lower interest rates on fixed income investments. Insurers will also face higher cost of credit due to general shortage of liquidity in the financial markets and potential downgrades by rating agencies.³³ Additionally, some negative economic impact may be felt from slower new premium growth due to the recession.

Because the insurance industry is statutorily required to maintain high capital reserves,³⁴ it was largely unharmed by the liquidity crisis. Therefore, insurance companies did not

³⁰ Due to the complex, high-risk nature of their business, financial guarantee insurers are separately licensed and regulated, and are generally prohibited from writing traditional property & casualty insurance. *See, e.g.,* N.Y. INS. LAW §§ 6901-09 (2005). New York regulates most of U.S. financial guarantee companies, so New York's regulation is most relevant. *See* Eric R. Dinallo, Circular Letter No. 19 on "Best Practices" for Financial Guarantee Insurers (Sept. 22, 2008), *available at* http://www.ins.state.ny.us/circltr/2008/cl08_19.pdf.

³¹ Securities class action suit jumped 80% since 2006. STANFORD LAW SCHOOL SECURITIES CLASS ACTION CLEARINGHOUSE & CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS - 2008: A YEAR IN REVIEW, *available at* <http://securities.cornerstone.com/pdfs/YIR2008.pdf>. *See also* FULBRIGHT & JAWORSKY, LLP, FIFTH ANNUAL LITIGATION TRENDS SURVEY FINDINGS, *available at* <http://www.fulbright.com/mediaroom/files/2008/Fulbright-FifthLitTrends.pdf>.

³² *See* Sam Friedman, *Faltering Economy to Spur EPL Suits, Bermuda Underwriters Warn*, NAT'L UNDERWRITER, June 6, 2008.

³³ *See* Andrew Frye, *Insurers May Be Downgraded By Moody's on Investments*, BLOOMBERG NEWS, Apr. 16, 2009.

³⁴ *See* Marsha Brown, *State Insurance Regulation: Cradle to Grave... and Beyond*, 796 PLI LITIGATION 355, 362-65 (2009).

experience the same solvency problems as other financial institutions.³⁵ Insurance companies are also subject to strict regulation limiting the types of investments they can undertake.³⁶ But, unlike life insurers, which can expect payout to occur decades after issuing a policy and therefore are permitted to pursue riskier long-term investment strategies, property & casualty insurers need to maintain liquidity and thus are limited to more conservative investments. Therefore, property & casualty insurers had relatively lower exposure to mortgage-backed securities, which are less liquid, long-term securities. The only victim of the 2008 financial institution failures caused by the credit crunch³⁷ was AIG, and only because it had two non-insurance subsidiaries that engaged in credit derivative speculation.³⁸ The demise of AIG demonstrates that in a financial crisis, an insurer can potentially become victim to an equivalent of a bank run, whereby policyholders, concerned about the solvency of the insurer, would terminate their policies and take their business elsewhere.³⁹ However, the bulk of property & casualty insurers did not suffer a crisis of policyholder confidence because unlike AIG, they were not affiliated with financial entities implicated in mortgage-backed securities and derivatives speculation.

Overall, the property & casualty insurance industry is well positioned to weather the financial and economic downturn. The industry was well-capitalized prior to crisis, and although

³⁵ However, this might not have been the case if the property & casualty insurance industry had been confronted with a very large catastrophic event, such as the terrorist attacks of 9/11 or Hurricane Katrina. In such circumstances, general conditions of constrained liquidity in the financial markets could, at the very least, force insurers to sell investments at a loss in order to raise cash for claim payments.

³⁶ See Brown, *supra* note 34, at 362.

³⁷ See discussion *supra* Part I.

³⁸ See BAIRD WEBEL, ONGOING GOVERNMENT ASSISTANCE FOR AMERICAN INTERNATIONAL GROUP (AIG), CRS REPORT FOR CONGRESS, at 2-3 (Mar. 16, 2009).

³⁹ See Ron Lieber & Tara Siegel Bernard, *Wall Street and You: Sorting Out the Changes in the Financial World*, N.Y. TIMES, Sept. 16, 2008, at 6.

surplus⁴⁰ declined from its peak in 2007, it is still historically very high at \$455bln.⁴¹ While in 2008 profits fell 96% from record highs, much of this decline was attributable to losses by mortgage and financial guarantee insurers, severe realized capital losses (a one-time event, barring further substantial declines in the stock market), and unusually high natural catastrophe losses.⁴² Additionally, the financial crisis coincided with a peak in the insurance industry's natural business cycle, which exacerbated the decline in profits. However, the property & casualty insurance industry profitability and solvency are affected primarily by catastrophic loss events and not by consequences of financial crises.⁴³ Economic downturns do not significantly impact the industry, because unlike the life insurance business, which relies on discretionary consumer expenditure, the bulk of property & casualty insurance business is statutorily or *de facto* mandatory,⁴⁴ so demand for insurance is inelastic. Therefore, while the insurance business may experience slower growth, it is unlikely to experience a contraction even in the current economic climate, unless unprecedented natural or man-made catastrophic events occur.

B. Political Impact: No Shift to Federal Regulation

⁴⁰ Funds in excess of reserves, available to pay for unexpected losses. ROBERT P. HARTWIG, FINANCING CATASTROPHE LOSSES AMID A FINANCIAL CATASTROPHE 14-16 (Apr. 16, 2009), *available at* http://server.iii.org/yy_obj_data/binary/812839_1_0/bhccats.pdf.

⁴¹ *Id.* at 18.

⁴² *Id.* at 47, 57, 71.

⁴³ None of the prior financial crises, such as the 1988-92 savings & loan crisis, the 1997 Asian financial crisis, or the 2001 dot-com stock market crash, had a significant impact on the property & casualty insurance industry.

⁴⁴ For example, auto liability and workers compensation insurance is statutorily mandatory; homeowners insurance is required by mortgage lenders, renters insurance is increasingly required by landlords, and various forms of liability insurance are ordinarily required in commercial transactions between businesses or professionals. Consumers typically cannot choose not to carry these types of insurance.

Presently, insurance is regulated by the states.⁴⁵ Because insurance industry has historically been an important player in the financial markets, any significant disturbance in the financial markets generates calls for regulatory overhaul.⁴⁶ In the past, states have always been able to preserve their regulatory power. However, this time may be different: insurance regulation is certain to attract federal government's attention after the government was forced to undertake expensive nationalization of AIG (even though non-insurance subsidiaries were responsible for the collapse). Additionally, fears of systemic risks within the insurance industry are rampant. Consequently, recent proposals for federal regulation have included establishment of an Office of National Insurance, Office of Insurance Oversight, or Office of Insurance Information, and introduction of an Optional Federal Charter.⁴⁷

Proponents of federal regulation, including life insurers, large property & casualty insurers, reinsurers, and brokers, argue that uniform federal regulation would eliminate the burden of redundant state requirements, improve oversight of systemic risks, and more adequately address the challenges posed by the globalization of insurance services.⁴⁸ These groups advocate a dual federal/state regulatory system similar to the one used for banks, which would let insurers choose whether to be regulated by the federal government or the states.⁴⁹

⁴⁵ Gramm-Leach-Bliley Financial Services Modernization Act, Pub.L. 106-102, 113 Stat. 1338 (Nov. 12, 1999); McCarran-Ferguson Act, 59 Stat. 33 (Mar. 9, 1945).

⁴⁶ See, e.g., FAILED PROMISES: INSURANCE COMPANY INSOLVENCIES, H.R. DOC. NO. 93-190 (1990) (a report on a Congressional investigation following the Savings & Loan crisis).

⁴⁷ See, e.g., Nonadmitted and Reinsurance Reform Act of 2007, H.R. 1065, 110th Cong. (2007) (as passed by House, June 25, 2007); Insurance Information Act, H.R. 5840, 110th Cong. (2007); Nonadmitted and Reinsurance Reform Act of 2006, H.R. 5637, 109th Cong. (2006).

⁴⁸ See *Perspectives on Modernizing Insurance Regulation: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. (2009) (statement of Frank Keating, Pres. & CEO, American Council of Life Insurers); Arthur D. Postal, *P-C Industry Split On Regulatory Reform; Insurers at odds, with Democrats likely to overhaul financial services oversight*, NAT'L UNDERWRITER, Jan. 5, 2009, at 10.

⁴⁹ See National Insurance Act of 2007, S. 40, 110th Cong. (2007).

Opponents of federal regulation, including state regulators and many property & casualty insurers, argue that introducing federal regulation would result in duplicative requirements, that state regulators are better qualified to address specific needs of particular companies,⁵⁰ and that it was the federally regulated commercial and investment banking industry that created and succumbed to the financial crisis, and not the state-regulated insurance industry, which emerged unscathed.⁵¹ While the latter argument is inaccurate in the sense that credit default swaps were not in fact regulated by the federal government, the argument is valid in that it was the federal government that failed to properly regulate these risky securities.

Although a new bill proposing an optional federal regulatory framework for insurers was recently introduced,⁵² since the agitation over the nationalization of AIG has subsided and it became clear that the insurance industry is not experiencing a systemic problem, it is unlikely that such legislation will be adopted in the near future.⁵³

III. Impact of the Crisis on Public Adjusters

A. Insurer Conduct: Reduced Coverage and Reluctance to Pay Claims

Although the property & casualty industry is well positioned to survive the financial crisis and the economic downturn, the new reality is that investment returns may not return to their peak levels for years, and this will have a significant and lasting impact on the way

⁵⁰ See INSURANCE INFORMATION INSTITUTE, INSURANCE HANDBOOK FOR POLICYMAKERS (2009); Arthur D. Postal, *P-C Insurers To Pass On Federal Bailout Funds, But Life Insurers Eager To Sign On*, NAT'L UNDERWRITER, Nov. 3, 2008, at 6.

⁵¹ See Sam Friedman, *AIA, NAIC Debate Whether Subprime Woes Mean Feds Can't Regulate Insurers*, NAT'L UNDERWRITER, Aug. 11, 2008, at 6; Jim Connolly, *Blame Feds, Not States For AIG Mess, Regulators Contend*, NAT'L UNDERWRITER, Sept. 29, 2008, at 7.

⁵² National Insurance Consumer Protection Act, H.R. 1880, 111th Cong. (2009).

⁵³ See Arthur D. Postal, *Federal Regulation Unlikely in 2009, FDIC Says*, NAT'L UNDERWRITER, Dec. 1, 2008, at 6.

insurance companies manage their business. Because insurer profits are principally composed of investment income and underwriting profit,⁵⁴ the decrease in investment income will have to be compensated through an increase in underwriting profit. Although the industry enjoyed record underwriting profits in 2006 and 2007, this was largely due to modest natural disaster losses; in actuality, insurers have been relying on investment gains so heavily that there has been absolutely no underwriting profit between 1979 and 2003.⁵⁵ Ordinarily, increased emphasis on quality underwriting would take the form of more careful selection of risks and more conservative pricing. However, in the current economic climate, neither of these strategies is available to insurers: excess capacity in the industry and slow or non-existent growth of new business (due to business downsizings and falling housing and auto sales) make the market extremely competitive, preventing insurers from raising premium rates or turning down riskier applicants.⁵⁶ Because insurers cannot improve underwriting profit through premium increases, they will have to find ways to reduce claim payments and expenses.

One way to reduce claim payments is to use tighter policy language: public adjusters should be prepared to see reduced coverage, broader exclusions, more sophisticated restrictions, and narrower definitions. Another way to reduce claim payments is through more adversarial claims handling and adjustment practices. This problem may be exacerbated by the fact that during periods of economic slowdown, claims tend to increase as policyholders who have seen their net worth shrink diligently pursue every available source of compensation in the event of a loss. However, in difficult economic times, fraudulent claims tend to increase as well, as some

⁵⁴ Underwriting profit is the amount by which collected premiums exceed claim payments and expenses.

⁵⁵ HARTWIG, *supra* note 40, at 63-64.

⁵⁶ See Caroline McDonald, *P-C Insurers Face Competing Economic Pressures, Making Price Hikes Problematic*, NAT'L UNDERWRITER, Jan. 12, 2009, at 6.

policyholders attempt to extract all possible value out of their insurance policies. In the current economic environment, property insurance fraud is particularly likely because many homeowners have found themselves owing more on the mortgage than their property is worth.⁵⁷ Therefore, public adjusters can expect insurers to show increased claim scrutiny and reluctance to pay.

The easiest way to reduce expenses is by reducing the workforce, which can contribute to lengthier claim adjustment times as well as a deterioration of claim handling practices due to increased workload for insurer's adjusters. Another reason that public adjusters and policyholders may experience increased claim payment delays is that insurers earn interest on the claim payment amounts ("float") for as long as this money remains in their possession.⁵⁸ Under current conditions of constrained liquidity and growing economic pressures, float has an increased value to insurers. However, low interest rates have somewhat reduced the incentive for insurers to carry a large float. Additionally, slow premium growth and competition within the industry are motivating insurers to strive to retain customers.⁵⁹ Furthermore, insurers who fail to pay promptly can face statutory penalties and risk of bad faith non-economic damages; however, examination of settlement practices in large tort cases during recent years reveals that

⁵⁷ See Daniel Hays, *Could Subprime Mortgage Crisis Drive Desperate Homeowners To Commit Arson? Investigators fear financial pressures may prompt policyholders to burn their houses*, NAT'L UNDERWRITER, Feb. 25, 2008, at 12.

⁵⁸ See Jay M. Feinman, *Incentives for Litigation or Settlement in Large Tort Cases: Responding to Insurance Company Intransigence*, 13 Roger Williams U. L. Rev. 189, 199-200 (2008).

⁵⁹ See Phil Gusman, *Adjusters Urged To Keep Brokers In The Loop On Status Of Claims*, NAT'L UNDERWRITER, June 23, 2008, at 10 (noting that "without the client, we don't have a business" and urging adjusters and brokers to present "a united front" and provide "timely, efficient, effective, and friendly" service).

these incentives may be overrated.⁶⁰ Therefore, public adjusters can expect to run into difficulty obtaining reasonable settlements and prompt claim payment.

B. Theft and Vandalism: Higher Number of Claims

The combination of deteriorating economic conditions and a glut in the housing markets is likely to lead to unusually large number of houses being abandoned or neglected: houses bought as investment properties (especially houses bought to be flipped), houses bought as second homes, foreclosed properties, and commercial properties whose lessees or owners went out of business. Uninhabited houses are more likely to suffer vandalism and theft.⁶¹ Public adjusters should watch out for abandoned/neglected property limitations in policies: typically, there is no coverage if property had been vacant for 30 to 60 days. In such cases, public adjusters should check whether the property contained furniture or other personal property, this could make it “unoccupied” but not “vacant” and, depending on the definitions used in the policy, possibly covered.⁶² If damage to the property was caused by arson, public adjusters should check whether fire and vandalism are listed as separate perils in the policy, because in such cases coverage for arson by vandals may be available under the fire damage provisions.⁶³ Lastly, in cases of expensive residential or commercial properties, public adjusters should verify

⁶⁰ See Feinman, *supra* note 58.

⁶¹ See David J. Price, *Vacant Property: A Growth Opportunity* Agents can boost commissions as economic woes leave properties empty, NAT'L UNDERWRITER, May 19, 2008, at 25. Even empty houses experience theft of copper wiring or appliances, as well as theft-related vandalism.

⁶² Myers v. Merrimack Mut. Fire Ins. Co., 788 F.2d 468 (7th Cir. 1986)

⁶³ United Capital Corp. v. Travelers Indem. Co. of Ill., 237 F. Supp. 2d 270 (E.D. N.Y. 2002); Nationwide Mut. Fire Ins. Co. v. Nationwide Furniture, 932 F Supp 655 (E.D. Pa. 1996); Johnson v. State Farm Fire & Cas. Co., 2008 WL 4724322 (Mich. App. Ct. 2008).

whether policyholders have excess and/or surplus policies which cover fire, vandalism, and possibly theft.⁶⁴

C. Economic Slowdown: Fewer Policies, Lower Settlements

Average U.S. house prices have been falling continuously since 2007. Lower real estate prices will translate into lower policy limits, resulting in lower settlements and, consequently, lower income for public adjusters. In addition, high foreclosure rates, fewer housing starts, and growing business closings and bankruptcies may translate into fewer homeowner and business interruption policies, and thus less business for public adjusters.

However, the uptrend in natural catastrophes will likely more than compensate for any economic downturn-related declines in business: nine of the twelve most expensive natural catastrophe events in the U.S. occurred since 2004; the number of catastrophic events reached a ten-year high in 2008, and made it the fourth most expensive year in the insurance industry's history.⁶⁵ 2008 losses were also largely due to unusual causes such as hail, thunderstorm, wildfire, and inland storms and flooding, occurring in unusual states.⁶⁶ Studies show unmistakable trend toward increased frequency and severity of natural catastrophes. To the extent that this trend continues, public adjusters can expect to be involved in working with increasing numbers of claims.

D. Catastrophic State of State-run Catastrophic Insurance Plans

State residual markets for catastrophic events have ballooned to 12.5 times their 1990 exposure level, with the bulk of exposure concentrated in Florida (Citizens) and Texas

⁶⁴ Hopefully, agents are already taking the initiative to actively market these policies. See Price, *supra* note 61.

⁶⁵ HARTWIG, *supra* note 40, at 72-77.

⁶⁶ CARL HEDDE, U.S. NATURAL CATASTROPHE UPDATE 8 (MunichRe, 2008).

(TWIA).⁶⁷ The situation of the Florida funds is particularly alarming, especially in light of the scandals of State Farm Florida's projected insolvency in 2011 and its withdrawal from the state,⁶⁸ and Allstate's suspensions due to multiple complaints regarding claims-handling.⁶⁹ Funding the state-run catastrophic plans is becoming increasingly challenging, with a significant portion financed post-event, and both private and state insurance entities' balance sheets having been ravaged by the subprime crisis.⁷⁰ Unless substantial reforms are implemented prior to the next large-scale catastrophic event, policyholders may experience difficulty recovering.⁷¹ Furthermore, once state governments become heavily invested in catastrophic insurance, financial solvency considerations will likely lead them to be less protective of policyholders than they are presently. In addition, policyholders will likely lose recourse to courts that they had when catastrophic insurance was provided by private insurers. Instead, remedies will be limited to administrative appeals and hearings, similar to those available for Workers Compensation and Social Security claims. Therefore, the trend toward nationalization of catastrophic insurance is a negative development for both policyholders and public adjusters.

E. Political Innovation: No Near-Future Impact on Public Adjusters

It is unlikely that insurance regulation will, after many years of unsuccessful attempts, be finally wrestled away from the states. In fact, considering that the problems at AIG were caused by speculation in credit default swaps at its non-insurance subsidiaries, a more logical regulatory

⁶⁷ See HARTWIG, *supra* note 40, at 90.

⁶⁸ See Daniel Hays, *State Farm Won't Free Fla. Captive Agents; Carrier rejects state pitch to let producers sell homeowners cover for other insurers*, NAT'L UNDERWRITER, Feb. 9, 2009, at 10.

⁶⁹ See, e.g., Matt Brady & Arthur D. Postal, *Allstate Suspended in Florida*, NAT'L UNDERWRITER, May 19, 2008, at 8; Daniel Hays, *Florida Court Keeps Allstate in Business*, NAT'L UNDERWRITER, Feb. 2, 2008, at 29.

⁷⁰ HARTWIG, *supra* note 40, at 92-100.

⁷¹ See Matt Brady, *Fla. Homeowners Market May 'Collapse' If Big Storm Hits This Year, Fitch Warns*, NAT'L UNDERWRITER, May 31, 2008, at 6.

intervention would be a reversion to a version of the Glass-Steagall Act,⁷² which had prohibited holding companies from owning financial subsidiaries such as the ones that led to the demise of the AIG; however, such a development is even less likely than centralization of insurance regulation. However, even though it has become evident that there are no significant systemic risks within the insurance industry that would warrant federal regulation at present, policymakers continue to be concerned with the need to modernize insurance regulation.⁷³ Current proposals for federal regulation of the insurance industry concern primarily solvency rather than business conduct, and thus do not have significant relevance to the public adjusting profession. However, if the insurance industry were to be subjected to federal regulation, public adjusters could eventually transfer the authority to license public adjusters from states to the federal government. Insurance producers succeeded in getting the NARAB reform bill⁷⁴ to pass in the House, and although it did not become law, the next attempt may be more successful. If efforts to streamline insurance industry regulation continue, and if public adjusters can push through legislation permitting federal licensing of public adjusters, it would solve the problem of the few states that continue to refuse to license public adjusters.

Conclusion

Just as the property & casualty insurance industry, the public insurance adjusting profession can expect to weather the current economic environment well, and emerge largely unscathed.

⁷² Glass Steagall Act, Pub. L. No. 73-66, 48 Stat. 162 (1933).

⁷³ See *Perspectives on Modernizing Insurance Regulation: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. (2009).

⁷⁴ National Association of Registered Agents and Brokers Reform Act of 2008, H.R. 5611, 110th Cong. (2008) (establishing licensing reciprocity for insurance agents and brokers that operate in multiple states).