THE CERTAINTY OF UNCERTAINTY

*If you’re not confused, you’re not paying attention - Tom Peters*

Markets hate uncertainty and no markets hate uncertainty more than the insurance markets. Unfortunately, uncertainty is exactly what 2010 holds for the financial services industry. The only likelihood we can predict with any confidence is that premiums for the industry are likely to remain high. While premium averages may be slightly off the peak we saw in 2009, underwriters are being more careful than ever about parsing risks and assigning premiums that reflect the true nature of the underlying exposure.

During the meltdown of 2008, it was understood that we were looking at a major correction and that commercial banks, investment banks, hedge funds and securities companies were all going to suffer. As the bailouts continued and the dust started to settle in 2009, it was clear that large banks would be rescued and that there were significant opportunities for new investors.

And now? No one is certain if the commercial real estate market will continue to slump, causing community banks to keep failing at the current record pace. No one is certain if regulatory reform will actually take place and what impact it would have on larger institutions and hedge funds. Finally, no one is certain if shares of rescued banks will continue to rise and if opportunistic buyers will continue to appear.

In fact, only one thing that is certain. Uncertainty.

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**PREMIUMS PAID BY FINANCIAL SERVICES PROVIDERS**

**ACTUAL AND PREDICTED MARKET CYCLE OVER FIVE YEARS**

![Diagram showing the actual and predicted trends in premiums paid by financial services providers over five years, with discount/increase at renewal data for each year from 2005-2011.]
COMMUNITY BANKS ARE CERTAINLY STRUGGLING

It is believed that the phrase “too big to fail” was first coined by Al Smith, the former governor of New York in 1936. He wasn’t talking about banks, he was talking about New York itself. However, the phrase has become inextricably linked with large money center banks and has darker implications. If certain banks are too big to fail then there must be some that are not too big to fail. While 2008 was the year that the large banks were saved because of their critical role in the financial system, 2010 may well be remembered as the year when regional and community banks were allowed to fail in record numbers because they were perceived as nonessential or lacked the political clout of their larger competitors. Of approximately 8,000 banks in the U.S., 2% could be shuttered before the end of the year.2

The sheer number of closures and the hits taken by the Deposit Insurance Fund have also forced regulators to rely heavily on the purchase and assumption method (P&A) of insolvency resolution. This is the method by which the assets of troubled banks are purchased and absorbed by healthier banks. (Contrast with the payout method, in which deposits are simply paid by the FDIC.) Since the beginning of 2009 over 60% of all bank closures have involved some sort of purchase and assumption. These closures create substantial opportunities (and risks) for the acquiring banks and their insurers. They also create uncertainty.

Meanwhile, large institutions are by no means free of uncertainty themselves. They may have received a disproportionate share of TARP funds and bailout money, but broad risks remain. Shareholder suits and lingering liability from the financial crisis threaten to haunt money center banks for years to come. The uncertainty represented by these legal actions has financial service insurance carriers alarmed.

MAJOR REGULATORY REFORM IS A MAJOR UNCERTAINTY

With the credit markets in full retreat by the end of 2008, a groundswell of political support for the radical reformation of the financial regulatory system seemed unstoppable. However, in politics, momentum does not always mean change.

After months of contention and frustration it appears that legislators have virtually abandoned any hope of a bipartisan solution. For the moment it appears that Democrats, led by Senate Banking Committee Chairman Christopher Dodd and House Financial Services Committee Chair Barney Frank, are likely to introduce a unilateral offering.

The bill proposed by Senator Dodd in March is not as ambitious as the House bill passed in December and does not contain all the reforms sought by the Obama administration. However, if some version of the 1,336-page bill is adopted it would still represent the most sweeping revision of financial regulation since the New Deal.

Highlights of the bill include:

- A Consumer Protection Bureau, within the Federal Reserve, to guard consumers from abusive and deceptive practices.
- A Financial Stability Oversight Committee chaired by the Treasury Secretary that would have authority to make recommendations regarding capital and leverage to limit unimpeded growth of financial institutions and even force divestiture if necessary. The bill would restrict proprietary trading and investment in hedge funds by commercial banks.
Improved bank oversight by eliminating the Office of Thrift Supervision (OTS) and moving all banks with $50 billion or more in assets to Federal Reserve supervision. Nationally chartered banks with less than $50 billion would remain with the Office of the Comptroller of the Currency (OCC) and state chartered banks and thrifts would fall under the FDIC umbrella.

- Creation of a regulatory framework for derivatives.
- Required registration of hedge funds that manage over $100 million.
- Creation of a new office within the Treasury Department to monitor the insurance industry.

Passage is by no means certain. Senate Democrats are one vote short of the 60 needed to overcome procedural roadblocks sure to be thrown up by Republicans. If Dodd can cobble together enough votes to get the bill through the Senate, it would then have to be merged with the measure approved in December by the House before unified legislation could be sent to President Obama to be signed into law.

**PIECEMEAL REFORM IS CERTAINLY POSSIBLE**

If the larger reform bill is stymied by partisan politics, reform is not dead. Various bills instituting narrow but important changes could still work their way through the political gauntlet. Here are two possibilities:

- The Protect our Recovery through Oversight of Proprietary Trading Act (PROP Trading Act). Introduced by five Democratic senators, the bill enacts some of Paul Volcker’s initiatives. The former Fed chairman has been an outspoken advocate that banks should not be allowed to “gamble” with federally insured deposits through means of proprietary trading.
- A bill that would qualify derivatives as credit exposure between banks and affiliates. This would restrict the trading of derivatives between related banking entities. This seemingly small change could have major ramifications on how banks manage their exposures.

**ARE WE CERTAIN OF ANYTHING?**

While we cannot be sure how the year will unfold in terms of regulatory change and bank failures, we do know that financial services companies must carefully differentiate themselves in the insurance underwriting market. They will need partners that understand their specific exposures and related risks.

Of that we are certain.

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3 In perhaps the most glaring example, the court-appointed examiner in the Lehman Bankruptcy case has recently asserted that a number of large institutions may have assisted Lehman in disguising the true extent of the firm’s debt.