Capital Constraint and Risk Shifting, An Instrumental Approach

We test the risk-shifting (“asset substitution”) hypothesis using data on property-casualty insurance companies. The main sources of losses for these firms are natural disasters and similar exogenous events, providing us with a strong instrument for financial distress. In addition, about one-third of our sample firms are organized as mutual companies, which are not able to easily raise new equity, allowing us to examine the interaction between capital constraints and risk-shifting incentives. After a shock that depletes their capital, mutual companies shift their asset portfolios toward riskier bonds, and reduce the extent to which they protect themselves through reinsurance. In contrast, stock companies do not increase risk significantly after exogenous losses; instead, they issue stock. These results are consistent with firms preferring to manage risk in general but adopting a risk-shifting strategy when reducing leverage quickly is not an option.