(1)

E. Looking at U.S. Insurance Exchange Experiences: Two Post-Mortems and a Hopeful Prognosis

1. The New York and Florida Exchanges

On March 31, 1980, New York Governor Hugh Carey cut the ribbon opening the trading floor of the New York Insurance Exchange amid great fanfare and expectations. Within four years the New York exchange had become a major reinsurance market in the United States with its aggregate syndicates ranking as the eighth largest U.S. reinsurer by premium volume ($345.6 million in gross written premium) and fifth by policyholder surplus ($182.6 million).

The expansive forecast of an independent economic impact study prepared in 1981 for the exchange no longer seemed so farfetched; $1.2 billion in premium volume by 1986 and $5 billion by 1991. The New York exchange was clearly becoming a major U.S. alternative to Lloyds.

Just three years later, however, the exchange was closed, with eight of its syndicates declared insolvent and the rest withdrawn or in run-off. A draft actuarial study of six of the insolvent syndicates concluded that the shortfall of assets to meet ultimate liabilities of those syndicates was in excess of $170 million, and the estimates of the shortfall for the entire exchange ranged from $900 million to $1.5 billion — a direct unrecoverable drain on the capacity of the insurance market in the United States.

Two other exchanges also appeared in the early 1980's — in Miami and in Chicago. Neither of these exchanges received the media and industry attention heaped on the New York exchange, and the one in Florida met the same fate as the New York exchange. The other — the Illinois Insurance Exchange — remains as the sole survivor of the three. In looking at the experience of insurance exchanges in the U.S., a number of questions must be asked first:

- What caused the collapse of the New York and Florida exchanges?
- Why has the Illinois exchange — with a fraction of the industry support received by New York — succeeded?
- Can the Illinois exchange sustain its success and continue to grow?
- Will the New York exchange re-emerge someday?

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(2)

MAKING THE EXCHANGE WORK FOR YOU

> Does anyone care about the New York, Chicago and Florida exchanges except that two are gone?

Who could blame the more than 600 ceding companies reinsured by insolvent New York exchange syndicates, or the investors faced with absorbing the shortfall, for cynically concluding "good riddance"?

The loss, however, particularly of the New York exchange, has dampened the success in Illinois, and should be viewed a tragic lost opportunity which we may not have again for a long time.

An insurance exchange is a facility where brokers and underwriters can openly and freely exercise their expertise in meeting changing insurance needs and markets. The great promise of the New York exchange was the chance to create a meaningful U.S. alternative to the London market: not just Lloyds, but the satellite markets surrounding Lloyds as well. As the largest insurance consuming nation in the world, the U.S. needed – and still needs – a domestic focal point to serve as both a barometer and an implementer of change.

While the New York exchange lamented, "We could've been a contender," Florida was exposed as a pretender. Grandly named – or misnamed – The Insurance Exchange of the Americas, it appeared for a while to be succeeding despite a series of scandals and the lack of any significant industry support. In 1985, for instance, the exchange reported that its twenty-two syndicates wrote over $119 million in gross written premium, with net written premium of $105 million. But this showing was quite fragile and suspect. The policyholders surplus of the twenty-two syndicates was only about $30 million and, as we subsequently learned, many of the syndicates actually wrote far more than was recorded on the exchange. By 1986, although the Florida exchange reported gross written premium of $169 million and net written premium of $142 million, its aggregate surplus was reduced to $7.8 million – a net premium to surplus ratio of 18.2 to 1.

One of the provisions of the Florida exchange legislation that particularly stood out "restricted" syndicates to an 8.5 to 1 ratio of net written premiums to surplus. A former exchange official recently remarked – almost seriously – that the exchange might have succeeded had it adhered to that limitation.

The official wisdom is that the Florida exchange was a club run by

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unsophisticated managers unable to regulate themselves, with undercapitalized syndicates used by unscrupulous brokers and intermediaries to write highly questionable business.

What that description ignores, however, is that the Florida exchange legislation never authorized the organization of a true insurance exchange. All of the statutory authority for the effective control of an exchange market was granted to the Florida Insurance Commissioner, not the exchange board. For example:

- ▶ The Florida insurance commissioner, *not* the exchange, had the statutory responsibility for investigating and approving new members;
- ▶ The Florida insurance commissioner, *not* the exchange, had the statutory responsibility for review, audit and examination of exchange syndicates; and
- ▶ The Florida insurance commissioner, *not* the exchange's Board of Governors, had the statutory authority to discipline members of the exchange.

The legislation also provided for the Florida insurance commissioner and the Florida governor each to appoint two members of the exchange's board, and also spelled out in detail the operating procedures for the exchange, including the 8.5 to 1 net premium to surplus ratio. Notwithstanding this legislation, the exchange attempted to operate as a self-regulating exchange, even though the board of governors had no statutory authority to manage the affairs of the exchange.

In the final analysis, the Florida exchange was not an exchange at all, but an accumulation of insurance companies answerable to the insurance commissioner, not to the exchange market and its Board of Governors. The problem is, the exchange didn't know it, and neither did the commissioner.

With no one knowing who was in charge, or with everyone thinking somebody else was, the opportunities to take advantage of a totally undisciplined and uncontrolled market was a magnet for trouble. The failure of the Florida exchange was not a failure of an insurance exchange, but the failure of the participants to recognize that it was *not* organized as an exchange.

New York, however, *was* organized on a proper basis to operate as

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a successful insurance exchange. The Board of Governors had authority over its members; The insurance department had authority over the exchange, and significant rules and procedures were in place for controlling and overseeing the market. New York had no excuse for failing. But it did.

Since the closing of the exchange facility in November 1987, the exchange's Board of Governors developed several official reasons for the failure of the New York exchange:

> *First, poor timing.* By the time the exchange opened in March 1980, the market was already turning from the hard market of the late '70's to the infamous soft market of the early 1980's. With no history of good times to fall back on, the syndicates could not absorb the devastating effects of the soft market.
>
> *Second, the board concluded that the syndicate capitalization requirements were too modest.* Only substantially capitalized syndicates of $25 million and more should be allowed to operate in an exchange environment writing the high levels of excess and reinsurance available to an exchange market.
>
> *Finally, the snowball effect.* The board concluded that the attention brought by the insolvencies of eight of its syndicates at a time when the market was turning (from hard to soft yet again), prevented the exchange from taking advantage of the turn in the market, and heightened the concerns of the market over the continued viability of the exchange.

While these reasons may seem compelling enough, there are several other factors which should be considered, particularly if we are interested in understanding how an exchange should work. For instance:

Much of the business written on the exchange in its first few years was directed business of dubious quality from many of the syndicate's own investors. Therefore, considering the time and the amount of premium written, it may appear to some that not only were others directing garbage to the exchange, it was directing garbage to itself.

Further, there is no correlation between the size of a syndicate (and some syndicates achieved significant size through growth) and the success or failure of that syndicate. In the tightly controlled environment the New York exchange was designed to be, size should be an

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element of availability and prospects, not an excuse for insolvency brought on by overwriting.

Also, in the independent economic impact study I referred to earlier — the one that predicted $5 billion in written premium by 1991 — there was one prediction which was right on the money. The report stated that by 1986 the exchange would have two hundred employees. The exchange did in fact have two hundred employees in 1986. The problem was that under the economic impact study the two hundred employees were to be processing $1.2 billion in business, while in fact the exchange's two hundred employees were processing one-fourth of that amount. In other words, the exchange became a cumbersome inefficient operation which continues to be a drain on its remaining members long after its demise.

But the most glaring and disappointing failure of the exchange management was its lack of effective self-regulation over its market.

Self-regulation does not mean an absence of regulation. In fact, a properly run exchange should be a very highly regulated market. In this regard, it is interesting to note that the legal tools and the information that the New York exchange board had available to it were not used in the control and operation of the exchange.

Every syndicate and broker on the exchange was required to record all transactions with the exchange central processing facility. All premium payments were to be made through the exchange facility, and all claim payments by syndicates were to be remitted through the exchange facility. The exchange, therefore, had available to it — instantly — all of the data with regard to all transactions written on the exchange. The constitution of the exchange also granted the exchange board extensive powers and authority over its members including examination and disciplinary authority.

A look at the authority of the exchange board over an impaired or insolvent syndicate would make a conscientious regulator green with envy. The board was authorized to:

- Restrict sales by type of risk;
- Increase surplus or capital requirements;
- Require security deposits;
- Issue cease and desist orders;

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– Suspend or restrict a member's authority to transact business on the exchange;

– Place a syndicate under conservatorship or rehabilitation;

– Require a syndicate to reinsure or assign all or part of its accounts;

– Borrow funds for the purpose of rehabilitation of a syndicate; and

– Declare a syndicate insolvent and petition the Superintendent of Insurance to seek an order of liquidation.

Regulators who are receiving more and more criticism for their failure to respond to insolvencies or potential insolvencies on a timely basis, would love to have the access to the information – as well as the authority – that the exchange board had available to it.

However, with all of that authority and access to information, the only consistent action taken by the Board of Governors of the New York Exchange over the eight insolvent syndicates was to petition the Superintendent for their liquidation. A tremendous opportunity had been presented to the exchange board to make a meaningful statement for effective self-regulation. The opportunity was lost and, in the process, so was the exchange.

Clear evidence of this lost opportunity is found by a look at what happened to the eight insolvent syndicates subsequent to the filing of petitions for liquidation by the New York Insurance Department *(see Table I-1 p. I-COMM-37)*. All disasters present a laboratory of experience for the future, and the exchange insolvencies are no exception.

What a laboratory! The New York exchange has given us the unique opportunity to look at eight reinsurance companies of approximately the same size all being declared insolvent in the same jurisdiction at about the same time.

Table I-1 illustrates what has happened to these eight reinsurance entities. Four of these entities fought the liquidation and ultimately succeeded in having their plans of rehabilitation approved and implemented by the courts. The other four were placed into liquidation and are currently under the jurisdiction of the New York liquidation bureau.

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Table I–1

NYIE SYNDICATES DECLARED INSOLVENT 1986 & 1987

SELF REHABILITATION v. STATE LIQUIDATION

Syndicate in Self Rehabilitation	Date of Show Cause Order	Date of Court Liquidation or Plan Approval	Stated Insolvency	Stated Impairment	Unpaid Liabilities Per Draft NYIE Actuarial Report	Amounts Paid to Cedants Under Rehab Plan or Liquidation	Contribution by Security Fund
Burt	10/30/86	7/25/88	$3,194,025	$5,394,024	$45,900,000	$16,987,160	$2,640,500
Candon	7/12/88	12/20/88	$3,900,065	$6,100,065	N/A	$10,602,422	$2,320,000
First New York	10/31/86	5/17/88	$2,516,293	$4,716,293	$56,600,000	$25,896,000	$ 500,000
KCC	11/9/87	4/18/88	$7,349,459	$9,549,459	N/A	$6,354,440	-0-
TOTALS			$16,959,842	$25,762,841	$102,500,000	$59,840,022	$5,460,500
Syndicate in State Liquidation							
Heartland	12/22/86	4/9/87	$14,038,105	$16,238,105	$26,600,000	-0-	-0-
Pine Top	12/21/87	2/29/88	$4,639,675	$6,839.675	$22,400,000	-0-	-0-
Realex	3/16/87	12/30/87	$8,078,286	$10,278,296	$40,000,000	-0-	-0-
U.S. Risk	10/23/87	1/7/88	$1,411,721	$3,611,721	$19,600,000	-0-	-0-
TOTALS			$28,167,797	$36,967,797	$108,600,000	-0-	-0-

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While the timing was similar, and the perceived amount of insolvency was roughly the same, the results to-date are startling. Almost $65 million has been repatriated into the insurance marketplace through the rehabilitation plans pursued by the four syndicates. On the other hand, not one dollar has been re-entered into the marketplace by the four syndicates in liquidation.

What the four rehabilitated syndicates sought – and finally succeeded in obtaining – was the imaginative use of the powers and authority which the exchange board had been given, but did not use.

The lessons to be learned from this chart go far beyond just the topic of insurance exchanges and the scope of this discussion. There is much food for thought about the implications of this chart for the future rescue of financially troubled reinsurance companies. Just because these syndicates were members of an insurance exchange rather than individually licensed reinsurance companies does not change the observation that state-managed liquidation may not be the best answer for dealing with impaired or insolvent reinsurance entities.

2. The Illinois Insurance Exchange

Let's now turn to a more positive note:

The Illinois exchange is succeeding as an insurance exchange. It has developed a model of discipline and self-regulation which so far has held it in good stead in the market. It has grown into a significant surplus lines market. And without the fanfare or attention given the New York exchange it has had the opportunity to grow at a constant, steady pace. The Illinois exchange also learned from the problems and failings of its brethren in New York and Florida.

Whether the Illinois exchange can continue to flourish will depend in part on its own willingness to be disciplined, particularly in the soft markets when the temptation to write business of low prices is greatest. As the experiences of the New York exchange have taught us, growth of premium volume does not guarantee success of the facility. In addition, the Illinois exchange must weather the strong negative feelings about insurance exchanges which have been created by the collapses in New York and Florida.

Furthermore, the Illinois exchange has yet to be tested in a financial crisis involving any of its syndicates. Its ability to handle such an emergency successfully should insure its legitimacy and enable it to

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face a more certain future. Cedants to syndicates on the New York exchange were badly burned and expected more help from the facility. They did not get it. Until an exchange steps forward and demonstrates that it controls its own marketplace in a time of difficulty, the general marketplace may not fully accept that facility as a significant insurance market.

3. Future Prospects

Finally, let's look at the prospects for the future of exchanges in New York and other jurisdictions. Nobody is sure that the industry or the regulators in New York would be satisfied with less than a monumental exchange facility rivaling Lloyds of London. On that basis, it is highly doubtful that there will be an insurance exchange in New York any time in the foreseeable future.

On the other hand, if regulators and investors could agree on a more modest, tightly controlled facility that is allowed only to grow slowly over a period of time which would allow it to demonstrate market confidence, something positive could emerge from the ashes in New York. Numerous proposals have been advanced for the reactivation of the exchange facility, but the existing entity and the broken expectations of the past have thus far prevented any of those possibilities from being pursued legitimately.

The failures of New York and Florida have also effected other jurisdictions, including the province of Ontario. A well-thought-out and studied exchange structure was evolving in Canada until the Ontario government withdrew its financial support. Since there was limited industry interest to start with, the effort died; although the legislation remains on the books.

Legislation also exists in the state of Texas, but again, in view of recent history, no action has been taken to activate an exchange under that legislation.

The best hope for the development of a meaningful and significant exchange market in the U.S. remains in Illinois. Until the Illinois exchange has faced and survived financial crisis, however, and proves through time that its regulatory efforts are effective, it will continue to be a closely watched — but modest — enterprise. Once it has crossed that hurdle, however, the perception of exchanges in the U.S. and perhaps Canada should change for the better. Perhaps then the

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exchanges can provide the kind of market tempering effect that is so badly needed.

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