STEWART ECONOMICS, INC.

# THE NEW YORK INSURANCE EXCHANGE

## Future Directions

A Report

Prepared for

The Board of Governors

The New York Insurance Exchange, Inc.

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# THE NEW YORK INSURANCE EXCHANGE

## Future Directions

## INTRODUCTION

This report is in four main parts -- History, Fundamentals, Recommendations and Execution. All are cast in terms of the original purpose of the Exchange and improvements possible in its general role and legal framework. Since, in some areas, experience has taught that the original purpose and framework might be modified to good effect, we have noted the possibility at various points in the text and, from time to time, have added suggestions that would go outside the existing purpose and framework.

The result has been two sets of recommendations with many features in common. The main set stays within the existing purpose and framework, and the second set gets into matters of structure as well. For comparison purposes, they are set out side by side in the fifth section of the report, Summary of Recommendations. The final section is our general conclusions.

# I. HISTORY

## The Idea

In 1978, the idea of an American market patterned on Lloyd's caught the attention of insurance and government people in New York. It looked like the perfect time for such a venture.

About three years before, casualty insurance markets in the U.S. almost dried up. The few companies willing to write it charged very high prices. A lot of business went to Lloyd's. By 1978 the crisis had passed, but brokers were still anxious to develop new markets.

At the same time insurance companies were prospering again. Rate increases more than compensated for the sudden inflation a few years earlier, and industry returns rose to unprecedented levels. There were plenty of funds for investment in a new facility. Competition was not yet a problem. In fact, many insurers were extrapolating recent growth in premiums and saw future capacity shortages.

Government welcomed a new insurance venture. In 1978, New York City was in the midst of a fiscal crisis. The

City's economic base had been declining for many years. Not only had manufacturing left the City, but then construction was depressed, securities firms were consolidating, and insurers were moving away. The State was receptive to legislation authorizing the establishment of the New York Insurance Exchange.

The Lloyd's form appeared an efficient way to mobilize new insurance capital. It promised operating economies of scale for new entrants and for brokers. Many hoped that tax advantages of insurance accounting might be available for individual investors. Finally, an American Lloyd's had a lot of romance. It combined industry and national and local pride with business need and a glorious role model.

Perhaps closer attention should have been given to the soundness of the Lloyd's analogy in this time and place and to the fact that, in mature financial markets, other suppliers do not stand aside for a new entrant and those in need do not rest with the first promising response. Those sobering points are discussed in the next two sections.

## What Has Happened

In some ways the New York Insurance Exchange has fulfilled its founders' expectations. It has become a significant insurance market. The Exchange is accredited for reinsurance in 35 states and for surplus lines in 38. Gross premium volume is now over $300 million, and total syndicate capitalization stands at about $200 million. Over 35 syndicates are underwriting risks, and over 100 brokers are members.

In other ways, however, the Exchange has not fulfilled the expectations of its founders. Specifically, it has not become a major source of insuring capacity in today's tight market. Among the chief reasons are (a) operating difficulties, (b) inability to mobilize capital, talent and a lead system, and (c) poor underwriting results combining with thin capitalization, raising doubts about financial security.

The first reason, back office problems, is not unusual for a startup operation. While the Exchange has improved its processing and is cleaning up the claims backlog, opinions differ as to the amount of progress. In any event, the earlier experience has made potential syndicate investors wary. Brokers are reluctant to place new business on the Exchange when they are still having trouble collecting old claims.

The second reason why the Exchange has not been a big participant in today's tight market is that it has been unable to duplicate some of the best features of Lloyd's, namely, easy access, face-to-face dealing between top brokers and underwriters, an efficient lead system and the ability to commit large amounts of capital on the trading floor.

Access for direct business for New York risks has been hampered by Free Trade Zone regulations, which in effect let Zone members select against the Exchange and impose procedural barriers to bringing direct excess and surplus lines onto the Exchange. Development of face-to-face dealing and a lead system have been hampered by low capitalization of syndicates and a tendency of underwriters to leave the trading floor.

The lack of capital is significant for itself, as the Exchange becomes a small follower for placements designed and led elsewhere or else a lead market of last resort. The lack of capital is also significant to the level of underwriting talent. Not having enough capital to generate the premium volume that would support a full-time, experienced underwriter, a syndicate either has a senior person spending much of his time away from the box underwriting other risks for the parent company or a junior person in charge with instructions to clear everything with the home office. Face-to-face dealing and leads can only develop with experienced people on the floor. Capital, talent and business tend to follow, and to wait for, each other.

The third reason why the Exchange has not met expectations is apprehension about the financial security of thinly capitalized syndicates with several years of bad experience, together with uncertainty about the Exchange's response to the problem.

The Exchange started up in the most fiercely competitive market in modern insurance history. It had no ballast of old and loyal business. It had fixed costs to cover and a name to make. No surprise that some syndicates got in trouble. But the problem is not so much a few troubled syndicates. Because of problems with security and with collectibility of reinsurance around the world, brokers and buyers now want to deal only with the most financially secure insurers and reinsurers. In general, that means big capital and long experience.

Since the Exchange is new, it might reasonably be expected to compensate for proven competence and reliability with even more capital, but as presently situated it cannot. The Security Fund was intended to provide financial comfort, but not to the full extent of the usual property-liability guaranty fund. The Fund has not yet been called upon and no one is sure when or to what extent it will respond.

So the great opportunities that its founders envisioned for the Exchange now elude it. As reinsurance capacity, the Exchange is being used to fill out tag ends. New capital entering the reinsurance business is going into other entities. Direct surplus lines are coming on but are a minor part of the Exchange's operations.

## II. FUNDAMENTALS

### Validity of the Idea

Was the idea of an American Lloyd's flawed from the beginning? We think the answer is no. The general notion of a trading floor for face-to-face dealing is valid, but it takes more than copying a structure to make a vibrant market.

Lloyd's has had over 300 years to prove that it can work superbly. But the insurance world could survive without a Lloyd's. One can imagine how it might work -- heavy reinsurance, big fronting, corporate slips, capitalized captives. That is just not how it has worked out. The reason is partly history and partly Lloyd's unique features.

First, history. In 17th century London, the center for news was the coffee house. Itself a new creation, the coffee house offered a place where people with common interests could gather and talk and gossip. With only an inadequate press and post, the gathering place was a natural, even necessary, creation. Coffee houses developed in the specialized business districts of London. It is no picturesque accident that Lloyd's, the unparalleled insurance market, grew up in Lloyd's coffee house, the most popular news center for the marine trade.

Lloyd's started when its physical setting was indispensible, and where insurance exchange blended naturally with information exchange, for insurance is a blend of money and information. It had a monopoly on marine insurance, a monopoly which lasted some 200 years. Lloyd's has grown from that natural and comfortable setting into one of the great financial centers, or information switches, in the history of the world and certainly the greatest one in insurance. It has had difficult times, but that is inevitable as major institutions evolve over centuries, the few that survive so long.

The idea of other Lloyd's, or insurance and information exchanges, has been about in the United States for over a century. The reason was not antipathy to Lloyd's but rather admiration and the desire to copy. Many American Lloyd's flourished in the late 19th century. Most were operated irresponsibly and did so badly that the exchange form was widely outlawed. Where permitted, the few well-run Lloyd's changed their form to avoid the others' bad reputation.

With today's technology for communication, travel and finance, the historical reasons for Lloyd's no longer matter. The unique institution that has evolved continues to thrive because it is an efficient marketplace and because it is there and the rest of the insurance buying and selling world is comfortable with it.

The efficiency starts with having experienced people deal face to face. Lloyd's puts the most experienced and most respected people from the broking side against their counterparts on the risk-bearing side. Efficiency probably goes up in proportion to the size, complexity and time pressures of the transaction. The opposite is the case in the hierarchical insurance corporation, where layers of decision making increase with the difficulty of the transaction and the system of promotion and reward takes good underwriters away from their profession and into management and, as an annoying and surely expensive by-product, seems to put inexperienced underwriters on the front line every day. At Lloyd's the best meet the best over the deal, and the backups back up.

The idea of creating an American version of Lloyd's thus was and still is a valid idea, though not all the reasons for Lloyd's success still apply. Having it in New York fits New York's role as a world financial center and home for the major insurance brokerage firms.

But underwriting boxes on a trading floor in New York are not sufficient to make the Exchange a major marketplace for insurance and reinsurance. Face-to-face dealing is still an excellent way to transfer information and to craft and execute big insurance transactions, but it is no longer the only way. New York is a world financial center, but not the only one. As New York is the center for U.S. insurance sophistication, it also has over a century of experience and habituation to the corporate form of doing an insurance business and the strict and direct form of government regulation of it.

The short of it is that New York in 1986 is not London in 1666. The need is here; the structure and style are valuable. But a simple analogy, though beguiling, is flawed. Romance, pride and the thrill of creation have done what they can. From now on, the Exchange succeeds or drifts down, ultimately lives or dies, on its ability to make practical contributions to those who deal with it and to offer good financial rewards to those who invest in it their talent and money.

## Role of the New York Insurance Exchange

The New York Insurance Exchange is a place to trade. It is not an insurance company. Hence the direction of the Exchange cannot be forced. It can only be anticipated and provided for.

The natural role of the Exchange is a broker market, just as Lloyd's and other exchanges have grown and worked most efficiently by bringing together many sellers and the numerous transactions of many buyers in an ordered, predetermined fashion by a smaller number of representatives for those buyers.

Most natural for the Exchange are the kinds of business to which brokers add the most value and where the costs of face-to-face trading are worthwhile. Those are treaty and large facultative reinsurance and innovative, direct surplus lines. The Exchange has no place in standard, simpler markets, which move on price and in which the Exchange has no special advantages.

Exchange syndicates, like Lloyd's syndicates, will follow much of the time, trusting their capital to another's skill. The key is being able to lead in some area. Large syndicates can follow, but small syndicates cannot lead.

Hence the Exchange should be at the end of the market which is heavy on capital and skill. That is consistent with the experience of Lloyd's and of the American security and commodity exchanges. All are institutions which were fostered by historical primacy, legal privilege and cartel restriction far more than by abundant capital or unique skill. As their special advantages broke down, the successful among them changed. Capital, skill and reputation carry them today.

A new institution such as the Exchange does not have those protections in its infancy, but at least it is not barred as it would once have been. The new setting will just allow it fewer mistakes.

For the Exchange to fulfill its natural role in treaty and difficult facultative reinsurance and in surplus lines, it will have to attract capital, skill and good business. That, in turn, means dispelling clouds from the past and getting set for an entirely businesslike future.

If the Exchange can do so, and execute well thereafter, all else will follow. If it cannot, nothing else matters. The self-reinforcing effect of success, drift or failure will take care of the outcome.

## III. RECOMMENDATIONS

The Exchange is a place to trade. It is new. It is part imitation and part invention. Its specific mandate, other than to succeed, was unclear. It was shaped by U.S. corporate insurance ideas to which it was supposed to be a reaction. It was dropped into a mature business and regulatory setting grounded on very different assumptions. It entered the market at the wrong time.

The wonder is not that the Exchange had trouble but that it worked at all. Now we are able to take an existing institution, put the troubles of the past out of the way of the future and prepare the Exchange to do what it should do -- large reinsurance and surplus lines.

That agenda, which is difficult to put into effect but fairly simple to think about, is set out in this section (Recommendations) and the next (Execution). The recommendations and execution stay within the original concept of the Exchange and its existing legal framework. In a few areas, it seems possible to accomplish our general purposes -- cutting with the past and making the Exchange attractive to capital, talent and business -- by modifying the original purpose and framework. We have noted those possibilities in the appropriate places, and they are summarized along with the main recommendations in the fifth section of report, Summary of Recommendations.

We offer four recommendations. First, reduce business uncertainty overhanging the Exchange from the past. Second, make the Exchange more hospitable to large capital and top talent. Third, increase freedom and decrease costs in the operating environment. Fourth, concentrate on what is within the Exchange's power to accomplish.

## Recommmendation #1 - Uncertainty from the Past

If the Exchange is going to succeed, it is going to have to convince present and potential investors and brokers that past problems will not become their problems.

The back office aspect of this objective is discussed in Recommendation #3 on operations. The other aspect is to reduce the debilitating uncertainty about the fate of several financially marginal syndicates and the impact on customers, brokers and other syndicates should they go under.

The governing documents of the Exchange are not entirely clear as to the rights and obligations of the Exchange, the Security Fund and the Insurance Department in these situations.

Hence the handling of the current, first ones is very important.

The Constitution and By-Laws set a 90-day period for aggregating syndicate insolvencies for equal rights against the pre-existing resources of the Security Fund. That period is now running. Whatever else is unclear about the Fund, it is clear that syndicates formed after the 90-day period (November 20) will not be liable for any capital or premium assessment with respect to syndicates declared insolvent during the period. The uncertainty flowing from those marginal syndicates and clouding the entire Exchange will be gone.

Accordingly, we recommend that before November 20 the Board of Governors declare insolvent all syndicates which are insolvent and petition the Superintendent of Insurance to liquidate them. This action should be taken without regard to promises of future funding, projections of profitability, effects of borrowing from the Security Fund or statement gains from future commutation of reinsurance treaties.

As soon as possible, the Board of Governors of the Exchange should publicly disclose its action with respect to the insolvent syndicates and officially request from the

Board of the Security Fund a statement for public distribution which would outline the response to be expected from the Security Fund.

The Exchange should not be worried about admitting syndicate insolvencies. Insolvency is and will be a fixture of the modern, competitive insurance world. The particular problems for the Exchange are, first, the doubt about whether it or any other self-regulatory body will take stiff and unpleasant action against its own constituents, and, second, the endless pall of uncertainty cast over the Exchange if it does not.

The pall of uncertainty is not an apprehension. It exists right now. It is not an abstraction. It is keeping capital and business away. Investors need to know their costs, and brokers need security for their customers.

If the response of the Security Fund to the present insolvencies does not allay the fears of investors and brokers, or if its direct and indirect costs appear too high in the light of its benefits, or even as a later stage in stripping the Exchange all non-essential features, it would be desirable to eliminate the Security Fund altogether. Such action would reduce the direct charges against premiums, would remove the contingent call on syndicate capital and would eliminate a level of information-gathering and regulatory expense and burden on the syndicates.

Elimination of the Security Fund would be a matter of balancing benefits against costs (including accreditation questions). It would not seem to raise questions of equity, since neither reinsurance nor surplus lines is covered by the State's general property-liability guaranty fund.

All moneys left in the Security Fund after it had been cut off would be held in trust for policyholders on business written up to that point. Later on, when all claims had been settled, the remaining funds could be returned to the contributors.

Thereafter, security for policyholders would depend on the usual factors, experience and capitalization, which are the subjects of the next recommendation.

## Recommendation #2 - Capital and Talent

For the Exchange to serve what we see as its natural markets -- treaty and large facultative reinsurance and large surplus lines -- it will need large financial resources and the underwriting skill to use them well.

The difficulty of implementing this recommendation is discussed in the next section (Execution). This section takes up the recommendation itself and why it is crucial.

The Exchange should seek a minimum capitalization of $25 million for at least a few, new or existing, insurance or non-insurance sponsored, syndicates. It should encourage the investors of such capital to utilize and protect it with top underwriting talent that is very well compensated.

Capital and talent in a few syndicates are the key to making the Exchange an important insurance market. Capital would respond to the financial security concerns of brokers who, because of uncertainty, disregard the Security Fund. Talent breeds efficiency. With quick decisions brokers can go on to the next risk. Talent is more likely to bring stability to a market. Good decisions last. Good underwriters, well rewarded, do not jump around.

Encouraging big capital and top talent onto the Exchange is crucial for its success for four other reasons: (1) it should naturally encourage a lead-follow system; (2) it should attract more investment; (3) it would let the Exchange take advantage of an excellent market opportunity, and (4) it would lessen the annoyance from some of the Exchange's other problems. Here are the details.

First, leads. Syndicates with capital and talent are likely to attract brokers' better risks. Other, smaller syndicates may recognize they would be much better off following those good risks than just filling out tag ends or providing capacity for risks that have been shopped everywhere else. Furthermore, syndicates, even if funded by insurance companies, are more likely to operate as independent entities and identify with the Exchange and thus encourage and foster a system of cooperation and following. The discipline of an underwriting lead system might encourage brokers to put the Security Fund in the background, where it belongs, and to view the Exchange's capacity in the aggregate.

Second, investment. The Exchange needs significant investment now, while the market is still tight and returns to investors can be demonstrated. The need is greatest where the Exchange is most free to write -- reinsurance. The logical source of capital for Exchange syndicates today is investors forming new insurance entities. Established insurers have been soured by their earlier experience and, more importantly, they see plenty of other opportunities for using their capital. New money needs to be convinced that the Exchange can work, if that is only a vote of confidence of a major investor or two.

Third, timing. In today's market there is a severe shortage of capital to underwrite excess and exotic liability insurance. It is not clear whether anyone can successfully underwrite those lines, but it must be done for business to go on. Right now, only a scattering of underwriters, mainly in and around Lloyd's, plus a few capitalized captives and reinsurers, are even nominally in the market. The Exchange, if it is to become an important, leading market, should be there too. Doing so requires big capital and the best people.

Fourth, other annoyances. New capital is likely to ameliorate, or at least shift attention from, other Exchange problems of high expenses, back-office errors and underwriters off the floor. Exchange revenues generated from the additional premiums will help cover expenses and hence reduce every syndicate's unit cost of doing business there. Larger, leading syndicates should reduce broker complaints about back-office problems. Lloyd's itself is not a model of excellence when it comes to systems or fast claims payments. Brokers will put up with a lot for an important market.

Brokers are tolerant because they need Lloyd's and because over the years they have learned how to accommodate its delays. Finally, if underwriters have enough capital to keep them fully occupied on the Exchange floor, they are likely to stay there.

If the steps recommended here and in the section on Execution are considered inadequate to attract sufficient capital, talent and business to the Exchange, two further steps would be available although outside the original mandate and framework of the Exchange.

First, existing insurance companies, rather than only their restricted-purpose subsidiaries, could be invited onto the Exchange and also invited to establish underwriting offices on or near Exchange premises, much as is done with the company peripheral market at Lloyd's and, more recently, with the new building for the Institute of London Underwriters and its insurance company members. Such an arrangement would make the full capital of participating insurance companies available to the broker market of the Exchange and would make business conveniently available to participating companies. Hence it would at once address the challenges of capitalization and sufficiency of talent.

A second step outside the original mandate, which could be taken either separately or in conjunction with the first, would be to raise significantly the minimum capitalization of syndicates to, say, $10 million or more. If there were no grandfathering of existing syndicates with lower capitalizations, the effect would be either to force the smaller syndicates to merge or to leave the Exchange. Such action would fit the general tendency of these recommendations -- toward large capital and top skill, both best suited for large transactions. Increased minimum capital would be particularly appropriate if insurance companies were allowed directly onto the Exchange market and if the Security Fund were eliminated, thus confirming the existing practice on the part of brokers of assessing the security of individual syndicates rather than the Exchange as a whole.

## Recommendation #3 - The Operating Environment

As the Exchange grows into a major marketplace, its operating environment will be accepted as the price of doing business there. Right now, however, the Exchange is in tough competition with other, established marketplaces and other ways to enter the insurance business. In its efforts to attract investors, it should make the Exchange a desirable, not difficult, place to do business. That suggests a review of the Exchanges rules, processing and regulation.

First, rules. The Board has established several guidelines for syndicates which limit writings and retrocessions. Their purpose is to prevent abuse of the Exchange and to keep syndicate financials within acceptable leverage or solvency margins. Such guidelines are common regulatory tools and are standard ways that self-regulating exchanges police themselves. But the Exchange is not yet a tested and fully formed institution, and a mature-institution model may be too restrictive.

For example, retrocessions off the Exchange are limited to 50% of gross premiums. Should a new reinsurer, which has small capital and less ability to spread risk internally or which is testing new business, be required to retain so much? Syndicates are also limited in their premium writings by their policyholders' surplus. In general, premium-to-surplus guidelines are perverse. They encourage writing more when prices are going down and discourage it when prices are going up. They are a relic of the fire insurance cartel of 50 years ago, when price corresponded to rate and rate to exposure to loss. While the Exchange needs some rules regarding syndicate capacity, it should review its premium-to-surplus rules as to whether they are realistic today and in the long run.

More generally, in the haste to set the Exchange in motion and with the handiness of the insurance company as a model, the Exchange has probably adopted rules and restrictions which frustrate and stultify more than they are worth and which tend to set the staff of the Exchange against its business participants.

No one has a legitimate interest in the Exchange's being a timid bureaucracy any more than in its being a wildcat market. The question is the balance. We think the balance is now too restrictive. The only way to be sure, and to make wise changes, is for a review to be made jointly by representatives of the Exchange and its business constituents, subject by subject and rule by rule.

Second, processing. While the Exchange has gone a long way in cleaning up its past problems, especially in improving claims processing for new business, it needs to have a clearer vision of what it should be providing, now and in the future. One of the difficulties has been that the Exchange has tended to react to needs as they arose rather than plan the basic role of its back office.

The Exchange is a place to trade, not a company. As a place, it could provide (1) minimal, mandatory services for syndicates and brokers to be able to do business there, i.e., to meet basic operating and regulatory requirements, and (2) additional, optional services that vary with the market or custom of the syndicate or broker. The first is essential; the second is optional. Hence, the Exchange should focus its efforts on the minimal requirements and make them excellent, that is, simple, accurate, timely and cheap.

Syndicates that want additional services have the option of compensating and working individually with the Exchange or using outside vendors to satisfy their particular needs. In time, the syndicate association can help guide the Exchange's back office development. The key is that the optional services of the Exchange be fully costed and subject to market competition from vendors and from the internal capabilities of syndicates and brokers.

The widespread complaints that the office, staff and processing overheads of the Exchange are too high are probably correct (though comparisons with other markets are difficult) and, in any case, are serious because the view is so widely held.

The Board is well aware of those concerns and is dealing with them. We certainly agree and would only add that more is probably to be gained, especially in procedure and processing, by eliminating activities than by doing them more efficiently.

Third, regulation. As part of making the Exchange an easier place to do business, the staff should press ahead in getting admitted to states where it is not now and in eliminating the Free Trade Zone requirements.

In addition, the Exchange should work with the New York Insurance Department to reduce the cost of regulation, which adds to the cost of doing business on the Exchange. The Exchange was set up to be self-regulating, but it is also being closely watched by the Department. In time the Department should rely more on the Exchange's regulation. In the meantime, the Department should reduce its charges since it is duplicating work the Exchange is required to do, and the Exchange should continue to petition for such a reduction.

If the Exchange took the steps recommended above which are outside the original mandate and framework -- elimination of the Security Fund, admission of a direct or peripheral insurance company market and increased syndicate capital --

the information, processing and regulatory needs of the Exchange and the Insurance Department would be reduced. It would be consistent with the other three recommendations for the Exchange to eliminate all data gathering and processing functions which were not necessary. The Exchange would not then have to engage in such activities beyond those required for booking business, processing claims and preparing necessary accounts for the Insurance Department. Syndicates would not be required to take any other Exchange processing services. With the predominant participation being that of insurance companies and very large syndicates, it should also be unnecessary to offer additional services on an optional basis.

## Recommendation #4 - Priorities

The foregoing recommendations will be difficult to execute and ultimately may not do the job. But they probably will work if they can be done, and they have one other virtue -- they call for action by the Exchange and are within its capabilities. For example, the Exchange can make itself more hospitable to big capital than it is now and can make that accomplishment known. Whether big capital will then come is up to those who control it. The Exchange will have done all it can.

Making so obvious a point may be necessary because of the natural inclination of all of us, when frustrated or disappointed (as all believers in the Exchange are in part), to look outside for causes and villains. Effort is then diverted away from things we can control to things we cannot.

Two examples will do: taxation and insurance community loyalty.

Federal income taxation of insurance is based on the insurance company form and on statutory, corporate accounting, both of which antedate the federal income tax by nearly 50 years. American names at Lloyd's have tax advantages in both countries, by law, treaty and closing agreement. We may wish potential individual investors on the Exchange had the best of everyone else's tax position, but it is beyond the Exchange's ability to make that happen. It is mostly a dream and a distraction from matters within our capability.

Rather, the Exchange should focus on what is important, that is, making itself a place where investors can make money. Promising ideas and proven operations have no trouble attracting sufficient capital -- the U.S. has too much capital seeking too few good opportunities. Americans are accustomed to investing in and profiting from the corporate form. An Exchange syndicate needs only to be a promising business proposition to attract capital. It is not necessary to be a tax shelter too.

Insurance community support was essential to getting the Exchange started. Even so it came at a price, but now it cannot and should not be a factor in Exchange planning except to the extent such support is in the economic interest of community members.

That is as it should be. This is a competitive business. The Exchange is no one's only option. Brokers have security concerns and are developing their own pools of capital, where an Exchange syndicate might be a desirable alternative. Companies have more business and regulatory freedom in their own organizations.

This point goes back to the fundamentals discussed earlier. Insurance industry solidarity is no more a sound basis for the Exchange than is romance. The Exchange has to make it as a business and as a good place for others to do business.

* * * *

While the four recommendations are stated separately, they are not independent. Attracting capital cannot be done without the support of the other three, and none alone can put the Exchange in the direction of fulfilling its important role. All four must be taken up and well executed.

Whether it would be desirable to pursue the alternate recommendations that go beyond the mandate and framework is a matter for determination by the Board of Governors after some experience with the foregoing, more moderate, recommendations. If the more severe steps are necessary, they should be tried, but in full recognition that their greater promise is balanced by their being more controversial and, hence, more difficult to implement mechanically and in terms of gathering a consensus in support.

The present tight market is bringing a lot of changes to the insurance business. Rather than be passed by, the Exchange should begin to take action on the recommendations outlined above. Especially with regard to big capital and top talent, now is the time to capitalize on market opportunities. Nonetheless, the Exchange should have and exude patience. None of these recommendations is simple. But the Exchange is no mere cyclical play. It is for the long run or not at all.

## IV. EXECUTION

This report makes four recommendations. The Exchange should (1) reduce business uncertainty overhanging the Exchange from the past, (2) make the Exchange more hospitable to large capital and top underwriting talent, (3) increase freedom and lower costs in the operating environment, and (4) concentrate on matters within the Exchange's control.

The preceding section of this report (Recommendations) contains our suggested ways of executing the first and third recommendations, on reducing uncertainty and improving the operating environment. The fourth recommendation, on priorities, is largely a matter of attitude and approach.

That leaves the second, which is most important, most complicated and most difficult: the apparently simultaneous attraction to the Exchange of capital, talent and business. The rest of this section deals with that one challenge and with the key to answering it -- seeing that the three essential ingredients (capital, talent and business) need not be simultaneous.

## Chicken-and-Egg Problem

Because capital and talent and broker support are mutually reinforcing, they present a complex chicken-and-egg problem. They are synergistic once they get going, but it is hard to get them started. Capital will follow talent and good business, but talent and good business will not move without capital.

The Exchange has to start somewhere, and the logical place is with capital. First, big capital is more likely to be accompanied by talent to use it and protect it. Second, in today's tight market, big capital will attract the attenticn of brokers. Finally, and most important, the attraction of capital can be within the Exchange's influence if not control. The Exchange cannot force talented people to bet their careers or brokers to bring good business. The Exchange can, however, fulfill real and immediate objectives for certain kinds of investor.

## Logical Investors and Capital Organizers

The most logical capital for which the Exchange has a role is new entry capital, that is, insurance ventures just starting. Such venturers might include foreign interests, insurance or non-insurance, that want to enter the U.S.

market, American non-insurance interests that want to set up a captive or simply to gain experience in an unrelated business, and American insurers that want a separate vehicle for a new operation.

For such start-ups, the Exchange offers expedient entry due to: (1) regulatory recognition, (2) immediate scale economies of a back office already in place, and (3) variable costs because the syndicate structure lends itself to renting managers and services.

The logical organizers of new capital are brokers and syndicate managers. Brokers are well practiced in bringing together insurance buyers, capital, talent and related services to form captive insurance companies. The Exchange should be considered along with all the other captive havens. It has many of their regulatory advantages (quick approval, freedom from state guaranty funds, rate and form flexibility), and the tax advantages of going offshore have been sharply reduced.

Syndicate managers, while they have had less practice than brokers at it, are also in a logical position to bring capital to the Exchange. Particularly for managers that do not have a company market to turn to, it is in their immediate interest to have more capital to manage to spread their costs and to see better risks from brokers.

Less Likely Sources of Capital

Attracting capital to the Exchange must be on immediate practical and economic grounds, not on conceptual or romantic notions. Participants need to be shown that they can make money. Capital goes where it expects to be rewarded. The Exchange should thus not waste time on people who have no real need for it. That means being realistic about the role of insurance companies and investment bankers.

Established insurance companies were the initial capital support for the Exchange. The Exchange still makes sense for insurer sponsored syndicates in a number of circumstances.

The first circumstance is as a vehicle for doing something that cannot be done by the parent insurer. An insurer could leverage a talented underwriter's skills better in an entrepreneurial environment than in a bureaucratic one. Second, insurers oriented toward brokers, international operations, money center finance and New York City have sound business reasons for staying and growing on the

Exchange. Third, where allowed, insurance companies themselves might become participants on or around the Exchange in order to have convenient access to brokered reinsurance and surplus lines. Fourth, with state regulators becoming more restrictive on small commercial lines, and thereby incidentally on larger ones, Exchange syndicates can provide a more flexible market where such regulation is not needed.

Today, however, some insurers are less logical investors. They have plenty of opportunities for using their scarce capital in their own operations, and they tended to run their syndicates merely as extensions of the parent company anyway. We can be grateful for their contribution, but it is no failure of the Exchange to lose some of them now. That is not to say insurance company complaints about Exchange procedures and back office are not justified, but the economics of the market and not the complaints are driving the exits.

This point should be made clear both inside and outside the Exchange. Losing syndicates does worsen the expense load for those remaining, but the effort should be on getting the logical people on, rather than agonizing when the illogical ones leave.

The role of investment bankers in organizing capital should also be kept in perspective. That role is to bring together capital and promising ventures; they do not make the ventures promising. It is the individual syndicate's job to attract investment bankers to raise funds for them, on their ability to make money, market strategy, reputation, etc. The Exchange can only try to provide a setting in which such ventures will be successful.

## A Bigger Role for Big Capital

In attracting capital, whether new or additional investment in existing syndicates, the Exchange should work more closely with investors on their business plans and special needs, in order (a) to put to rest preconceived negative ideas, and (b) to shift attention to how the Exchange meets their needs.

The Exchange should also review the makeup of the Board of Governors and perhaps expand it to include more syndicate managers, so that big investors coming on can feel they are protecting their stake by having a voice in the Exchange's governance.

## The Exchange's Image

The challenges to the Exchange are real, as are its opportunities and the main actions it should take. But any business or business setting does depend on how it is regarded by others. That is especially true of insurance, which is necessarily an enterprise of trust and confidence, if only because payment precedes performance. In this world, good public relations are a real strength and bad public relations are a real hinderance.

The Exchange should project an image of a professional and sophisticated market, or more simply, a place where the best people would be proud to be. A strong marketplace will eventually help carry off the image, but meanwhile the desired appearance should track the desired reality -- competent, honorable, receptive, flexible and a good place to make and protect money.

## V. SUMMARY OF RECOMMENDATIONS

| Subject | Within Framework | Beyond Framework |
|---|---|---|
| Insolvent syndicates | Liquidate | Liquidate |
| Security Fund | Clarify | Eliminate |
| Capital | Attractive to non-insurance | Same, plus allow insurance companies directly or on fringe, and raise minimum capitalization |
| Rules | Fewer and more flexible | Same |
| Exchange processing | Minimum required, others fully-costed and optional | Smaller minimum; no options |
| Free Trade Zone | No prerequisite | Same |
| Regulation | By Exchange, with Department indirect | Same but less Department |

# CONCLUSION

If this report were seen as a series of questions and answers, it would look like this.

The first question is whether the idea of an insurance exchange in New York City was and is a good idea. Our answer is yes.

The second question is whether the Exchange is living up to the hopes of those who created it and up to its potential in the world insurance market. The answer is no.

The third question is whether the analogy to Lloyd's is a valid guide for the Exchange. The answer is that it is partly valid, but that the differences between the conditions at the founding of each institution are so great that the analogy should be pursued with care.

The fourth question is whether the Exchange can improve its operations and market position so as to fulfill a valuable, even leading, role in the insurance market place. The answer is yes, by concentrating on treaty and large facultative reinsurance and, to a lesser extent, on large surplus lines.

The fifth question is what should be in a specific program to achieve the objectives of the Exchange. Two sets of recommendations are set out in the report, one staying within the original framework of the Exchange and the other calling as well for action to modify the framework.

Our most general conclusion is that the exchange form of doing substantial and complex property-casualty insurance transactions, in a broker market, offers great advantages today, although it is not the historical necessity that Lloyd's was. While the New York Insurance Exchange has had its share of problems and false starts, it is in operation and has identified what needs to be done and can be done. It is in one of the three great insurance and financial centers of the world. If the exchange form is going to happen successfully on a large scale one more time, we should do all in our power to give it the chance to happen here.

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