THE ONCE AND FUTURE NEW YORK INSURANCE EXCHANGE

By Peter H. Bickford

This Article is dedicated to the memory of Roy Nelson, the former president of the New York Syndicate Members Association, who never stopped fighting for the continuation of the New York Insurance Exchange.

On March 31, 1980, The New York Insurance Exchange opened to great fanfare in Lower Manhattan. The Exchange was the culmination of several years of legislative, regulatory and industry effort to establish a Lloyd's type insurance market in the US – a market consisting of multiple syndicates, underwriting managers, brokers and intermediaries operating under a common set of rules on a common trading floor. The next day, April Fools Day, started the longest transit strike in New York City history. Some say this was an omen of things to come for the fledgling exchange. And after an initial period of spectacular growth and expansion, the Exchange ceased operations a short seven years after opening with a number of its syndicates having been declared insolvent and in various stages of receivership or run-off.

More than two decades later, Governor Patterson listed in his State-of-the-State message a number of economic initiatives to be pursued by his administration. Among them was a commitment to "rebuild the New York Insurance Exchange," adding that: "By bringing together the buyers and sellers of complex commercial insurance, the Exchange will reaffirm our status as the focal point of international trade and finance. It will also curtail the types of transactions that were unregulated that decimated the global economy."

By including the rebuilding of the insurance exchange in his remarks, the Governor has placed the full weight of his administration behind the idea first raised by Insurance Superintendent Dinallo in 2007, and endorsed by his successor and current Superintendent, James Wrynn. For his part, Superintendent Wrynn has moved the project from talk into action by establishing working groups of interested elements of the insurance and financial industries and the regulators, with the goal of developing a plan of action this year.

The idea of reestablishing the exchange, however, has its skeptics and naysayers. What has changed in the past two decades to make a Lloyds-style insurance exchange workable in the US today when it did not seem to work before? Why do we need another market in the middle of a seemingly endless soft cycle? How can an exchange overcome the regulatory and tax disadvantages of operating in the US? What assurances are there that a new exchange will not be as inefficient and costly as its predecessor? Why, indeed, even bother?

This article will look at the original exchange experience, addressing some of the more common perceptions and misperceptions about its demise and the pros and cons of "rebuilding" the insurance exchange today. This effort can only scratch the surface in discussing the multiple and complex elements and history of the Exchange. By addressing some of the more common perceptions and issues, however, it is hoped that a serious dialogue and consideration can be given to the effort to reestablish the insurance exchange based on a solid factual understanding of the original exchange – both its strengths and its weaknesses.

The Original Exchange: A Brief History[1]

The capacity crisis of the mid-70s was reflected in New York with the adoption in June 1978 of the "Free Trade Zone"[2] and insurance exchange legislation.[3] The insurance exchange legislation authorized the drafting of a constitution, which was adopted by statute in February 1979, leading to the opening of the Exchange a year later. The next several years witnessed extraordinary growth on the Exchange, primarily as a reinsurance market. By the end of 1984, it ranked in the aggregate as the eighth largest U.S. reinsurer by premium and fifth largest by policyholder surplus. The number of syndicates grew from sixteen on opening day to thirty-five active syndicates by year-end 1984, and the number of participating brokers exceeded one hundred, including most of the major national brokers and reinsurance intermediaries. The optimistic predictions of the

Exchange supporters appeared to be coming true. That optimism, however, proved to be misplaced.

The tight market that helped launch the Exchange legislation in the late 70's had disappeared by the time the Exchange opened in 1980. The rapid growth in premium volume coupled with the extreme soft market conditions of the early 1980's helped spark a growing impression in the industry that the Exchange was really the market of last resort; the "dumping ground" for the submissions from the bottom drawer that could not be placed anywhere else.[4]

As the premium volume grew, so did the losses, eventually leading several syndicates to stop underwriting new and renewal business, but these actions proved to be too little and too late. The seeds of financial trouble were present in the first few years of the Exchange. Finally, in August 1986, the Exchange Board of Governors declared five syndicates insolvent and petitioned the New York Superintendent of Insurance to liquidate four of them, and by fall 1987 the number of syndicates turned over for liquidation had grown to eight.

Although plagued by the adverse publicity of these insolvencies and the withdrawal of many of its major industry participants, as well as by a back-office operation that had not kept pace with its growth, the final straw appears to have been an action by the separate Board of Directors of the Exchange's security fund. In September 1987 the security fund's board of directors called down the $500,000 deposits of each of the underwriting members on the Exchange – a total of $25 million – to meet the potential claims against the security fund resulting from the declared syndicate insolvencies. This action took the Exchange members by surprise, and the resulting shockwave led to petitions to withdraw by all but ten of the remaining syndicates. The Exchange board acted to "temporarily" suspend all activity on the Exchange in November 1987. The Exchange never opened its doors again.

A Failure?

It may be easy to conclude from this history, as many have, that the great US exchange experiment was an abject failure. Such a conclusion would be wrong, however, and before there can be a reasoned discussion about restarting the exchange, this perception of total failure must be reexamined.

When the Exchange suspended operations in the fall of 1987, it had a number of syndicates that were solvent, well capitalized (for the business they were writing), well managed, profitable and – most importantly – willing and anxious to continue operating on the Exchange. A number of broker members had also developed successful exchange operations and were likewise willing and able to continue placing business with those exchange syndicates they had grown to trust and depend on as a market. These syndicates and brokers better than most understood the value of an exchange form of market and were successfully utilizing that knowledge and understanding to their advantage.

So why didn't they continue as an exchange? The simple answer is that after the Exchange's Board of Directors decided to close the facility, the rush was on not to be the last one standing on the sinking ship. That explanation, however, is overly simplistic and ignores some basic facts about the original makeup of the Exchange. It also ignores the role that fate often plays in history – even corporate history.

Loss of a Hero

Prior to the suspension of operations, the Exchange's most influential supporter was not on the Exchange board, Exchange staff or even a senior executive of a major insurance company or brokerage firm. He was the manager of the syndicate management subsidiary of one of the alphabet brokers, Johnson & Higgins. His name was Roy Nelson, and he tried in vain to convince the major powers on the Exchange board to find market solutions to the Exchange's problems, and to give those willing participants the opportunity to continue. As the head of the J&H syndicate managers and with the full support of his parent company, an internationally savvy broker, he had four active and successful syndicates under management with plans to add at least a half-dozen more. Roy was also the head of the Syndicate Members Association, which attempted to rally the voices of those members looking to continue. He and his colleagues understood the concept of the exchange and knew that given time to develop the Exchange could become a strong and significant market. But cancer struck Roy down in the months before the Exchange board acted to discontinue operations and force the remaining members to withdraw.

It is impossible to know if Roy would have been successful in getting the Exchange board to support continuation of the market, but given his persistence and his understanding of an exchange market, it would have been hard to bet against him. And how could he have staved off the "inevitable"? Perhaps by convincing the Exchange board and management to use the unique tools provided to it by statute, the Exchange constitution and by-laws, and the very nature of the exchange as a market.

Unused Toolbox

When the Exchange petitioned the New York Superintendent of Insurance to liquidate the first four syndicates in August 1986, many believed that it lost a golden opportunity to demonstrate to the industry that it could succeed as a self-regulated marketplace. Its constitution and by-laws, approved by the Insurance Department and the Legislature, provided the Exchange with significant powers over its underwriting syndicates. These powers included the types of authority generally granted to insurance regulators over insurers, such as the authority to:

- Restrict writings;
- Require an increase in surplus or capital requirements;
- Issue cease and desist orders;
- Suspend authority;
- Place a syndicate under its supervision; or
- Declare a syndicate insolvent and seek liquidation.

In addition, however, the Exchange had certain advantages that the state regulators did not enjoy. In particular, because syndicates could only write business through the Exchange facility, and the Exchange processed all business written by the syndicates, in theory the Exchange should have had much more timely and accurate information about the extent and character of the writings of each syndicate member. However, the Exchange did not take advantage of this access to information, as evidenced by its failure to stop the insolvent syndicates from continuing to write business long after they had overextended their capital resources.

The reasons for this failure were complex, including the blurring of the line between the Exchange as promoter of the market as well as its regulator, processing backlogs at the Exchange facility, inconsistent submission and reporting requirements and compliance issues, that prevented it from having any significant control of the information that should have been available to it.

Many members, both syndicate and broker, urged that the Exchange find a market solution to the problem rather than simply turn the financially troubled syndicates over to the State for liquidation. They argued that for the Exchange to be accepted as a viable market, it had to deal with the adversity of financially troubled syndicates to show the industry that it had the ability and the resources to address difficult situations. The Exchange, it was argued, should use its unique self-regulatory authority to work with the syndicate managers, the broker community and the Exchange's security fund to find a way to resolve the syndicate financial problems and keep them out of the State's liquidation process.

For instance, one of the proposed market solutions was for the creation of a new syndicate that would be the reinsurer of or assuming entity for the insolvent syndicate liabilities. This new syndicate -- which had the working name Syndicate 101 – would be capitalized by the existing members, take control of the remaining assets of the insolvent syndicates, and look for additional financial support from the Security Fund. This proposal was presented long before the Lloyd's market "invented" Equitas.

For whatever reasons, however, the Exchange's board and management took no steps to attempt to prevent the liquidation of these syndicates. Instead they simply turned them over to the State. In comparison, Lloyd's – faced with many of the same economic pressures and failures, only on a much greater scale -- used all available resources and opportunities, including the establishment of Equitas to wall off old liabilities, to address its problems and in time restored its financial bearings and prestige as a market of choice. *In other words, one could reasonably conclude that it was not a failure of the exchange market that resulted in the closing of the Exchange. Rather it was a failure of its management and leadership.*

Why Now?

Before exploring the pros and cons of a new exchange enterprise today, it is helpful to consider how the world has changed in the 30 years since the original exchange opened in 1980. Consider the following list, which is by no means exhaustive:

- The first Vermont captive insurance company was licensed in 1981.
- The first liability excess facilities were established in Bermuda in 1986.
- The Liability Risk Retention Act that allowed for the creation of risk retention groups and risk purchasing groups was enacted in 1986.
- In the 1980s a sidecar was an attachment to a motorcycle, a cat bond was getting to know your pet, and securitization was protecting your home.
- E-mail and Internet access did not become widely available until the 1990s (remember TELEX?).
- IBM introduced the first PC in August 1981 (16k of memory expandable to 256k); Apple introduced the first Macintosh (128k of memory) in a famous commercial during the Super Bowl in January1984.
- In 1980 it took from 3 to 6 minutes to fax one page via telephone.

- There were no laptops, cell phones, blackberries (other than the edible kind). SONY's Walkman, the grandfather of all portable electronic devices, had only been introduced in June 1979.
- The Exchange's modern idea of paperless recordkeeping was microfiche (try and find a readable copy of any of those records today!).

In other words, the explosion in alternative risk transfer vehicles and in data storage, access and retrieval had not begun when the Exchange was born. It is an entirely different universe today, and any consideration of the Exchange as a market needs to be viewed in light of these changes. That is not to say that the experience of the original exchange is not relevant. Quite the contrary! There are many lessons to be learned from that experience that still resonate today. The proof of this is Lloyd's itself.

The Lloyd's Experience

If an exchange form of market is irrelevant and wrong, then why is Lloyd's thriving? As stated, Lloyd's was faced with the same economic and business problems as the New York Exchange, but on a much greater scale. Many Lloyd's names (syndicate investors) were facing financial ruin from unlimited liability for a growing spiral of losses, and the market was facing a serious crisis of confidence. With persistence and determination, and with pressure and oversight of the regulators and lawmakers, Lloyd's managed to resolve those issues, including walling off the old liabilities through Equitas. In the process Lloyd's was also able to restructure itself for future success without destroying the basics of an exchange market.

When the New York Exchange first opened, many London critics scoffed at it allowing corporate syndicates and limited liability of syndicate members. In its own reinvention, of course, unlimited liability at Lloyd's has gone the way of the 10-cent cup of coffee (or 10 penny cup of tea). Equally important today, Lloyd's is a much more open facility than it was twenty years ago when business had to be placed through a relatively few number of Lloyd's brokers. While Lloyd's has always been an international market for insurance, it has not always been an internationally accessible place to do business for brokers, underwriting managers and investors. Many brokers and managers operating on Lloyd's today, however, are or are affiliated with international firms with widespread operations, and international insurers and investment groups participate through their own syndicates and managers. Yet with all this openness and competition, Lloyd's capacity continues to increase and the market thrives.

Which makes the argument often heard against a New York exchange – that it would result in unnecessary and unneeded competition for domestic companies – ring a little hollow! Many of these same critics have significant investments in the London and Lloyd's markets. In this changed world, the same international brokers, managers and investment groups operating at Lloyd's could actually welcome a vital, well-run exchange counterpart in the US. *In other words, there is no reason that a US exchange could not be a complimentary market with the benefit of closer, less expensive access to the US market, a more comfortable understanding of local business and insurance needs, and be a profit center rather than competition for many domestic companies.*

What About Taxes?

There are also many critics that state that without significant tax breaks for on-shore investments, the New York exchange cannot possibly succeed as an alternative to offshore excess and reinsurance facilities. There is certainly a basis for this argument, which is well recognized by Superintendent Wrynn who has made seeking some kind of tax "equalization" or leveling of the playing field a priority in his efforts for support. But focusing solely on the tax issues misses the mark regarding the potential benefits of an exchange form of market, and on the multitude of product and investment vehicles that can be developed for and written competitively on the exchange. It is these benefits and products that should be the focus today.

The legislative process is fickle at best, and reliance on some promise of relief down the road, while it should be pursued, should not the determining factor in proceeding with or abandoning the exchange project. Simply put, reestablishing the New York Insurance Exchange should not hinge on obtaining tax relief.

Basic Principles for a New Exchange

With "past as prologue" in mind, there are a few basic principles that should be observed by the working groups established by Superintendent Wrynn in considering the form and structure of the new exchange. Among these are the following:

- The Exchange should be industry driven and regulator supported. The regulators can provide the forum and support for the development of a plan, but the primary force needs to come from the insurance and financial services industries if there is to be any lasting success.
- The capital requirements for syndicates will need to be significantly stronger, not just in terms of the amount of capital, but more importantly through the application of risk to capital ratios that had not been developed or implemented in the 1980s.
- There will need to be a strong commitment on the part of both regulators and the industry to self-regulation and control of the market: with the regulators allowing the facility to develop rules controlling the operation and security of the market; and with the exchange leadership having the will to enforce its rules and its financial security requirements – a major failing of the old exchange.
- And a new exchange will need to take full advantage of the technical developments over the decades since the original exchange, including instant communications, virtual trading capabilities and real time access to and use of transactional and other data.

Under Superintendent Wrynn's direction a working group has been started to move the Exchange project forward. This working group has been divided into a number of sub-groups to focus on the following subjects: capitalization, tax, operations and technology, multi-state issues, markets and government relations. The work product of these various sub groups will then form the basis for the development by the full working group of an overall plan of action for a revised exchange market. It is these initial working groups that will largely define the shape, look and feel of the new Exchange. Organizations that have a serious interest in the reestablishment of the Insurance Exchange and helping with the process should make sure they are involved now rather than complaining about finished product later.

A New Beginning

Perhaps the most significant loss from the original exchange experience was the loss in time. If its board and management had found a way to allow the Exchange to continue operating so that the Roy Nelsons of the industry -- who understood the risk spreading value of a syndicated exchange market -- the New York Insurance Exchange might well be celebrating its 30th anniversary this March rather than the contemplation of its rebirth.

Those years cannot be recaptured, but we can learn from the experience of the original rather than dismiss the exchange concept as a waste of time and energy.

No market can or should be all things to all people! There are certainly many in the insurance and investment communities that will conclude that an insurance exchange makes no sense for them. There are many others, however, looking for new options and opportunities for which a viable, well-conceived exchange market makes sense. It is these people that need to step up and join the conversation.

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Endnotes:

[1] Some of the historical discussion in this article is excerpted from my 2004 article, *"What Ever Happened to the New York Insurance Exchange (And Why do we Care)?"* A pdf copy of that article can be obtained at www.pbnylaw.com, along with other articles and historical materials on the New York and other US insurance exchanges.

[2] The Free Trade Zone (See New York Insurance law Article 63, and Regulation 86 [NYCRR, Part 18B]) was New York's response to the perceived need for greater market flexibility by allowing licensed insurers in New York to write large or hard-to-place commercial risks free from rate and form restrictions.

[3] The insurance exchange legislation (See New York Insurance law Article 62, and Regulations 89, 89A, 89B and 89C [NYCRR, Part 18]) – originally conceived and for the most part operated as a reinsurance exchange – was a direct result of the concern over shrinking capacity and the flow of premium dollars overseas. Neither the free zone nor the exchange concept was able to obtain the necessary legislative and regulatory backing on its own; together, however, they were able to muster the necessary acceptance.

[4] Under the original §6201(b) of the New York Insurance Law, the syndicates could write reinsurance, direct insurance on risks located outside the U.S., and risks rejected by Free Trade Zone insurers. In 1982 the section was amended to add the ability to write surplus lines from other states (where qualified). However, by the time the Exchange started gaining some traction with the expanded surplus lines authority, the Exchange market was already in decline, and it remained essentially a reinsurance market.