Speaking of Exchanges...

Will the Phoenix Rise?

With all the attention and chatter these days about the health insurance exchanges under the Affordable Care Act, it is not surprising that there may be some jostled memories about the decades-old, failed attempts at establishing insurance exchanges in the US similar to or based on the Lloyd's model of a syndicated marketplace. But actually, the concept has never gone away and continues to be in the conversation today, albeit softly.

A Look Back

First a bit of history – or reminiscence, if you will. Long ago, in a time before the explosion of alternative insurance markets, including excess liability facilities, captives, risk retention groups, sidecars, cat bonds or insurance linked securities, there was a severe capacity crisis. With few options available at the time to bring new capital to the table, the idea of establishing a Lloyd's-type syndicated market in the US grew, resulting in the passage in 1978 of legislation in New York authorizing the creation of the New York Insurance Exchange (Article 62 of the NY Insurance Law). Unfortunately, before the Exchange could become a reality – it opened in early 1980 – the market cycle had moved from very hard to soft and was getting even softer. Shortly after the NY Exchange opened, two other states – Illinois and Florida – adopted authorizing legislation followed by the creation of exchanges in those states. Exchange authorizing legislation was also adopted in Texas and the Province of Ontario in Canada, and was under consideration in a few other states. The authorizing legislation remains on the books in New York, Florida, Illinois and Texas, although the Illinois statute is scheduled for repeal in 2017.

At its height in 1984, the NY Exchange annual report proclaimed that it ranked in the aggregate as the eighth largest U.S. reinsurer by premium and fifth largest by policyholder surplus, with 35 active syndicates. After this initial period of spectacular growth and expansion, however, the NY Exchange had ceased operations by 1987 — 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. Likewise, the exchange in Florida, over-optimistically named the Insurance Exchange of the Americas, collapsed in disarray and scandal in early 1987; and the Illinois Insurance Exchange, which later changed its name to the INEX Insurance Exchange, lasted the longest – into the early 2000s – but was never a significant market and is no longer active. The collapse of these insurance markets would seem to have buried forever any thought of attempting to create a syndicated insurance market in the US. But forever is a long time, and like a dormant flower in the desert, some things are never truly gone.

A Re-Emerging Idea

Fast forward twenty years, when in 2007 the NY Superintendent of Insurance, Eric Dinallo, discovered that the exchange authorization legislation, Insurance Law Article 62 along with three supporting regulations (89, 89A and 89B), was still on the books and started a dialogue with regulators and industry representatives about the feasibility of reestablishing an exchange market. Superintendent Dinallo's successor, James Wrynn, continued this dialogue and persuaded his then-boss, Governor Paterson, to endorse the exchange revival in his January 2010 State-of-the-State address. In that address, the Governor, with a nod to the recent past financial crisis, stated 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."

Superintendent Wrynn also moved the project from talk into action by establishing a prestigious group of interested elements of the insurance and financial industries, regulators and legislators, with the goal of developing a plan of action for the establishment of a new modern exchange facility. The working group included sub-groups covering such topics as capitalization, operations and technology, regulatory oversight and markets. In June 2010 the working group issued its recommendations for establishing a modern insurance risk exchange based on five basic principles:

1. Provide a strong and secure capital base to support regulatory and rating agency acceptance;
2. Provide for prudent and flexible oversight;
3. Provide an efficient, cost-effective and technologically advanced platform for the facility and its members;
4. Achieve 50 State access for syndicates on both a reinsurance and surplus lines basis; and
5. Provide as expansive a market as possible through legislative and regulatory support.

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Over the course of the next year a plan of action based on these recommendations was drafted, with the last draft dated July 25, 2011. Unfortunately, by this time, the legislation merging the New York insurance and banking departments into a new department of financial services was only a few months from implementation and the focus on anything other than the merger was minimal. The plan to implement the Working Group recommendations was never formally published and the exchange project once again became dormant. Was this finally the end for the idea?

Skepticism and Paranoia

The idea of reestablishing an exchange has had its skeptics and naysayers from the beginning. What has changed in the past three 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 seemingly endless capacity? 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? How would a new facility overcome the limitations of existing legislation that is outdated and not conducive to the needs of a successful facility? Why, indeed, even bother?

What is often missing in these conversations, however, is a factual assessment of the NY Exchange at the time of its closing. When the Exchange suspended operations in the Fall of 1987, it had a significant number of syndicates that were solvent, well capitalized (for the time and for the business they were writing), well managed, profitable and – most importantly – willing and anxious to continue operating on the Exchange. This growing community on the Exchange also included syndicate underwriting managers beginning to develop a following, and brokers willing and able to continue placing business with those trusted managers and syndicates. In other words, a true sense of market was developing on the Exchange. The problem was that the voices of these factions willing to continue the development of a true syndicated marketplace, were drowned out by the powers in control — primarily representatives of some major carriers and brokers that were never fully committed to the exchange concept, and who effectively forced the closing of the facility. Abandoned by the major companies and brokers, the remaining players could ill afford to risk the chance of being left behind to turn out the lights.

Adding to this historic skepticism arising from the failure of the old exchanges is the current concern – or paranoia? – of US insurance regulators for equity capital, which would play a major role in

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any modern exchange facility. Last April, New York's Superintendent of Financial Services, Benjamin Lawsky, speaking on the state of the US and world economies at a highly regarded conference in NYC, voiced concern about "private equity firms . . . becoming active in the acquisition of insurance companies." Why? Because "these private equity firms are more short-term focused – when [insurance] is a business that's all about the long haul." Subsequently, the New York regulator used this concern as the basis for imposing increased capital and financial controls on the purchase of two life insurers by private equity firms, and in December the Financial Condition Committee of the NAIC formed a new working group, the Private Equity Issues Working Group, to consider the development of rules to monitor and control risks associated with private equity and hedge fund ownership or control of insurance company assets. Considering that the most successful, oldest insurance market in the World, Lloyd's, is a syndicated market based on non-traditional capital, this singular attention to private equity is remarkable.

The Current Effort

The current support for a new, syndicated insurance risk exchange is driven largely by capital providers and global-minded insurance professionals that understand the value of a platform combining modern technology with syndicated capital in a controlled environment. These interests, however, recognize that such an initiative, while it would be industry-driven, cannot proceed successfully without the support of insurance regulators. With the momentum created by the Dinallo and Wrynn efforts, but which were halted by the silence of current New York regulators, it is a hope but not a certainty that the industry leaders who led the revival effort will be willing to continue to be available to the project should the NY regulators break their silence and support the concept.

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In view of the erosion of state regulation since the 2010 adoption of the Dodd-Frank legislation and the creation of the Federal Insurance Office (FIO), state regulators might want to take a closer look at the potential that could be created by a state-based insurance risk exchange facility. In its recently issued and long overdue report on the modernization and improvement of the system of insurance regulation, the FIO prods state regulators with a not-so-subtle threat of increasing federal involvement:

> "The need for uniformity and the realities of globally active, diversified financial firms compel the conclusion that federal involvement of some kind in insurance regulation is necessary. Regulation at the federal level would improve uniformity, efficiency, and consistency, and it would address concerns with uniform supervision of insurance firms with national and global activities."

The Plan to implement the Recommendations of the Industry Working Group listed the following benefits for state regulators:

- A highly capitalized, fully secure market;
- Prudent internal management structure;
- Significant security through a central fund;
- Collection point for premium and for allocation of taxes;
- Transparency through accessible data;
- On-shore market for high volatility risks; and
- Diversification through new sources of capital.

A truly state-based, nationally accepted insurance risk exchange could provide state regulators with an excellent example of their capability of supporting a seamless national market with the potential as an effective global competitor.

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 insurance risk exchange makes sense. If regulators are willing to step up and acknowledge the potential of such a market in the US, the conversation could once again turn into action. ●

NOTE: The author was General Counsel to the old New York Insurance Exchange, and was Special Advisor to the Exchange Working Group. A copy of the draft plan to implement the Working Group recommendations, and other articles and documents relating to the insurance exchanges have been posted by him on his website at http://www.pbnylaw.com/ny-insurance-risk-exchange/.

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