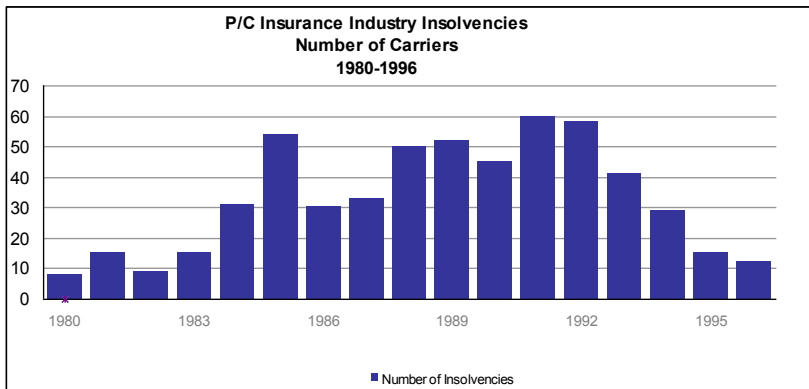


# Insurance Executive Review

Market Commentary on Current Developments within the P&C Insurance Industry

## Do We Need to Resurrect the New York Insurance Exchange?

A recent press report quoted New York Governor Patterson and Eric Dinello, the New York State Insurance Commissioner as having an interest in reopening The New York Insurance Exchange (NYIE) which closed in 1987 after 8 years of existence\* with extensive financial deficits. He sees the potential for success today that was elusive for the original NYIE when it opened for business in 1980. At that time it was considered as a new source of capacity following the casualty market crisis of 1975 but the NYIE idea took several years of developmental work before it was ready for business. Unfortunately that development time meant that the NYIE would not open it's doors until after the traditional market capacity was returning at the start of what came to be known as the "cash flow underwriting" period of the early 80's. At that time, investment opportunities with double-digit interest rates caused underwriters to consider writing casualty products at below loss (claim) cost on the theory that investment returns would more than offset the underwriting losses when ultimately paid. Since most casualty programs are considered "long-tail" business a considerable time delay in payment of claims was standard. However, the high interest/investment rates declined and its associated income was quickly outpaced by the escalation in claim and litigation costs.



This was the marketplace environment that greeted the NYIE as it tried to compete for business in an ever more competitive market. The competition forced prices so low that the NYIE had to close its doors in 1987, but not before 245 commercial insurers did the same as insolvencies soared to record levels.

Fundamentally it was a great idea with a very poor sense of timing! The question now is whether a re-born NYIE

some three decades later would suffer from the same poor timing issue in today's market?

Today's property/casualty insurance and reinsurance market is much different than the early 1980's although in many ways it remains the same. Competitive pricing cycles still are a hallmark of the commercial market environment hampering any steady-state condition.

Following the severe hard markets of 1975 and 1985, the commercial market underwent a number of material changes directly affecting commercial risk transfer issues. Further, the property catastrophe market expectations took on new dimensions following the terrorist attack and hurricanes of 2004 and 2005. These developments included new marketing vehicles, more responsive product innovations and access to new risk capacity.

**Marketing Concepts:** new methods of marketing risk financing capacity have come to the aid of the commercial

\* The legislation enacted in 1979 is still on the books in New York although inactive.

insurance buyers;

Captive Insurance subsidiary formations were limited in the 1970's to Fortune 1000 companies but flourished with each subsequent market cycle as captives brought insurance buyers' own capital to the market as a supplement and at times, in competition to traditional insurers;

Group and Mutual Captives (1975) brought companies and organizations together to share common risk exposures as well as capital and operating costs more efficiently than they might accomplish individually;

Risk Purchasing Groups (1986) under new federal intervention, allowed unaffiliated companies and organizations, contrary to state regulations, to jointly negotiate and purchase liability insurance terms as a group;

Rent-a-Captive (1985) facilities were offered or "rented" to unaffiliated companies who could not afford to organize their own captive subsidiary;

Protected Cell Captives (1990) were organized to allow funding for companies into designated accounts to protect their assets, as they were concerned with exposures of sharing risk with others in a conventional rent-a-captive vehicle;

Reinsurers acquiring Primary Carriers (1980's) was a strategy to allow reinsurers to become more responsive to the needs of commercial buyers and be able to directly help develop new risk management techniques.

**Product Innovations:** the market product vehicles to transfer/finance risk would undergo material change in order to respond to risk managers;

Captive Insurance (1975, 1985, 1990) the use of dedicated subsidiary captives by individual business organizations and institutions would increase significantly each time the hard market cycle would appear so they number over 5,000 today. Several states would note this offshore development and enacted state charter captive legislation to attract new formations "onshore". In many cases captives took claim frequency (greater predictability) and leaving catastrophe (severity) with commercial insurers. Captives brought a new source of capital to market and although dedicated for a specific purpose, it supplemented commercial risk capital;

Fronting Products (1975/1985) became a prevalent product in helping captives as certain insurance coverage required evidence of "admitted" insurance. So insurers offered this certification service for a fee and their unbundled services in claims administration, loss control, actuarial and other policy services;

Risk Retention Groups (1986) a federal provision that effectively allowed a "Group Captive" risk sharing vehicle among unrelated entities to be formed in any one state (rather than offshore) and allow it to offer insurance protection in any other state contrary to existing state licensing regulations;

Deductible Workers Compensation (1990) was an innovation as regulations had previously (since 1913) not allowed deductibles to be used in such policies. However, competition with risk financing alternatives was diverting business away from traditional markets and something had to be done;

Qualified Self-Insurance had been available in workers compensation since those first laws were passed in most of the states. It had always been a means for organizations to self-fund many kinds of risks via their Balance Sheet for those claims or risks that were not feasible to transfer via insurance because of availability or affordability issues.

**Market Risk Capacity:** the ability of the traditional market to supply adequate capacity to meet demand is usually a function of the expected return on the capital deployed and the risks to which it will be exposed;

New Funds (1976, 1986, 2004-2006) as hard market conditions emerge it is signaled by reduced capacity as capital is involuntarily (insolvency) or voluntarily withdrawn bringing product price escalations. When pricing in-

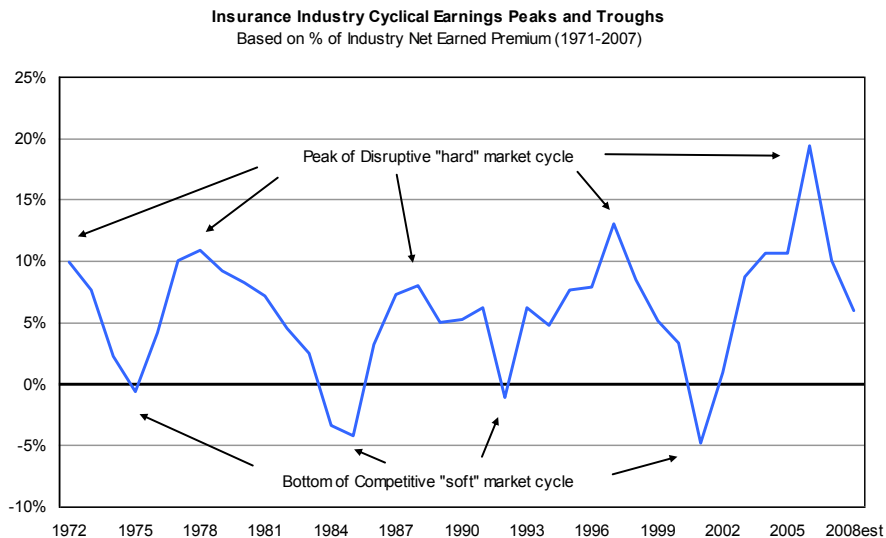
---

creases become better balanced against the related risks so profits are assured, the market is able to attract new capital that can ultimately bring downward pressure on pricing. In the time immediately following the worst two year hurricane period, the market attracted more than \$60 Billion of new capital;

Catastrophe Bonds (1995) have been around for more than a decade but as conventional reinsurance catastro-

phe risk capacity due to increasing natural events. These bonds became attractive to non-insurance investors who were looking for good capital returns but not interested in committing capital to a long-term reinsurance organization;

Side Cars (2000) became short-term special purpose vehicle insurance and reinsurance organizations used to tap into the global capital markets for added capacity featuring little operational cost and a definitive organizational life.



Note: the (years) shown in brackets above generally indicate the year in which these events or conditions first appeared or when their significance had a measurable impact on the US property casualty market environment

### Growth of Risk Management Practice

Underlying all of these market changes were new business risk management principles that were being employed by business firms, institutions and public entities. While limited in 1975 and years prior to global/multinational companies, the process of risk identification, quantification, reduction and finance options has become a management practice used by organizations of virtually any size. So today, risk transfer via commercial insurance is only one option to be considered when dealing with risk issues.

### Change in Traditional Market Suppliers

Over the years there has been a major shift by many national insurance carriers to move away from trying to compete in what has become clearly two distinct markets supplying commercial and personal lines insurance products. These were market products that had very diverse needs and shared very little in common resources. This was also true of life and benefit carriers such as Aetna and CIGNA selling substantial property casualty operations in order to concentrate on a more defined market instead of trying to be an "all things to all people" insurance market. While the number of market players remained the same the carriers focused on personal lines declined leaving the direct writers (i.e. exclusive agent carriers) with a dominating market share position. The property catastrophe market issues and capacity needs are much more prevalent in the personal lines market than in commercial. It is not clear how, if at all, the NYIE might play a role in that market still struggling with capacity issues.

### Conclusion

The basic question is whether a NYIE could be viable in today's market given the significant marketing, product

and capacity changes that have taken place since it was first introduced in 1980. Given these changes in nearly three decades, what need might the NYIE fill that has not been addressed by the free market process? In catastrophe protection would it allow capital to move freely so it could be redeployed elsewhere when it is no longer needed? Would the new NYIE be able to operate efficiently via today's technology and how would that infrastructure be built? Can a new NYIE attract foreign capital and what advantages would it hold over other insurance or reinsurance investments that can be formed offshore? Would the current "soft market" bring about the same timing mistake as the 1980 NYIE launch? Would similar naïve capital enter the market again?

Perhaps it is an effort to deflect interest away from the Federal government's attempt\* to put an optional national insurance company charter mechanism in place. There does not appear to be much conventional market support for a new NYIE, not even from other state regulators. In the past the risk management community, capital markets and the insurance industry, not always working in concert but seemed to develop meaningful market solutions when the need arose. The new NYIE may be the regulatory solution looking for the problem!



**Charles L. Ruoff CPCU**  
CR Market Strategies  
[crmarketstrategies.com](http://crmarketstrategies.com)

Mr. Ruoff is President of CR Market Strategies Inc. an insurance marketing and risk management consulting organization based in Garden City, New York. Mr. Ruoff has been involved in insurance underwriting, international insurance brokerage and alternative risk management businesses having held executive management positions with Continental, AIG, Johnson and Higgins, Sedgwick James, and Acordia (Wells Fargo). He has been a speaker/panel member at numerous industry events during his over 40 years in the insurance industry including RIMS, CPCU and other conferences. His articles have appeared in many industry publications and is a member of the Advisory Board of St Johns School of Risk Management and Actuarial Science.

---