

# onpoint

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## Syndication

for reducing the risk of carrier capsizes

**Joshua Stein, Chief Underwriting Officer, IronHealth**

Back in 2003, I wrote a piece that was published in the *PLUS Journal* called “Managing Market Cycles Through Syndication.” (*PLUS Journal*, January 2003.) The thesis of that article, written at the height of the hard insurance market, was that syndication could be a useful tool to “create[ ] stability and durability in the insurance placement” by increasing the number of carriers on the program. In a hard market, syndication can reduce the leverage any one carrier has over an insured and increase the insured’s ability to replace any carrier, hence improving stability and durability.

Fast forward to 2008, and we find ourselves in the depths of a soft insurance market. As typically happens when the insurance market softens, carriers are looking to replace lost revenue (e.g., from rate decreases and intense competition) by offering larger blocks of capacity to insureds. Brokers are inclined to recommend, and clients to accept, those larger blocks – especially when offered by financially strong carriers – because clients and brokers like the convenience and coverage consistency of fewer carriers on



## A funny thing happened on the way to placement consolidation.

a program. So, rather than syndicating programs, there is a movement to consolidate placements with fewer carriers.

But something funny has happened on our way to the placement-consolidation forum. As we sit here today, the U.S. finds itself in the middle of what many people believe to be the worst financial crisis since the Great Depression. This financial “virus,” which began with the collapse, or near collapse, of some of the nation’s largest and most venerable investment banks (Lehman Brothers, Bear Stearns, Merrill Lynch, etc.), has now infected virtually every corner of the financial services sector, including insurance companies. Several prominent life insurance companies are now teetering on the brink of insolvency as a result of “mark to market” rules, bad investment write-downs and the general decline of the global equities markets. These companies sold aggressive annuity contracts – billions of dollars of them – containing security clauses that require them to post collateral – or in some cases cash out contracts prematurely – in the event that the insurers’ investment portfolios decrease by a stated percentage. Needless to say, those thresholds have been triggered, and the resulting cash requirements are putting tremendous pressure on these companies. And for many property and casualty insurance companies, there is the “double whammy” of catastrophe losses (e.g., from Gustav, Ike, the California fires, etc.), combined with the massive devaluation of their investment portfolios. As of the writing of this article, the market capitalization of U.S. P&C companies is down more than 60% from its peak in mid-2007, a staggering reduction. As a result, many industry experts are predicting a hardening of the market in 2009, as carriers move to stop their financial bleeding.

The most publicized illustration of the sea change in the financial stability of the insurance industry is the meteoric downfall of American International Group (AIG), the largest insurance company in the U.S. In just a few short weeks, AIG went from financial juggernaut to the brink of insolvency as a result of the activities of one of its operating units, AIG Financial Products. During the housing boom, AIGFP had sold hundreds of billions of dollars of credit-default swaps, an insurance product designed to insure the viability of mortgage and other credit securities. In August of 2007, the chief executive of AIGFP, Joseph J. Cassano, was quoted as saying “It is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing one dollar in any of those transactions.”<sup>1</sup> A short year later, only a massive federal bailout has allowed AIG to stave off bankruptcy – at least for now – and proceed with an orderly liquidation of its assets to repay the loan.

The shock waves of AIG’s spectacular financial collapse, the rapid drop in market capitalization, and the decimation of investment portfolios across the insurance industry, can’t help but leave

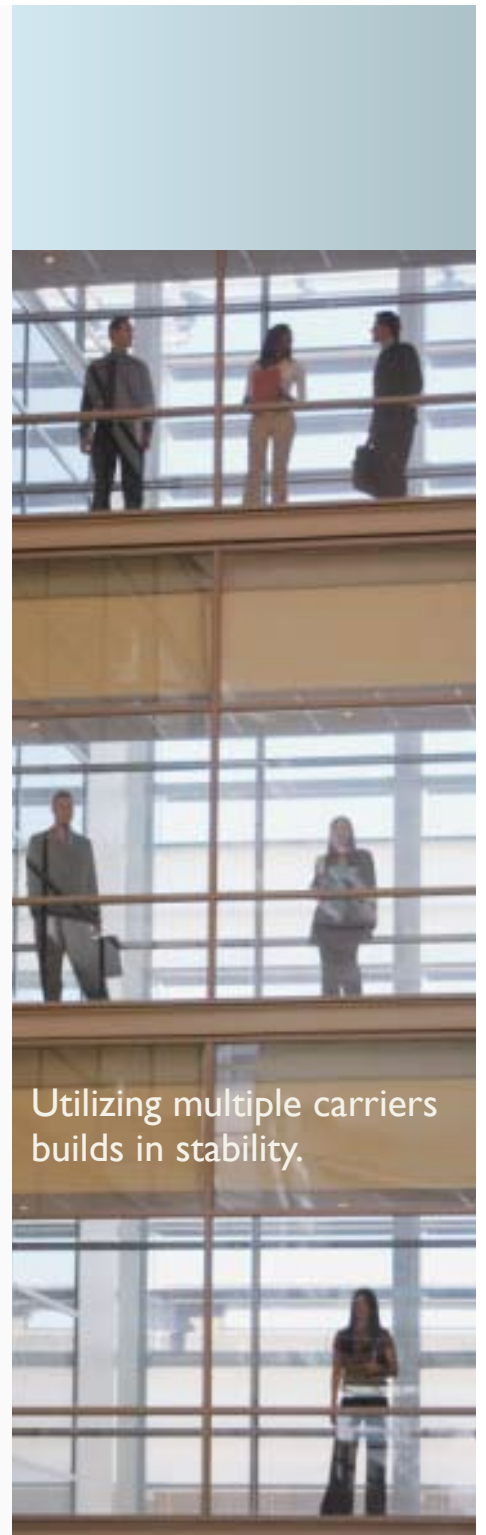
insurance buyers wondering, "Who is it safe to buy a policy from?" Virtually all insurers have exposure to the sub-prime mess, and to the massive financial fallout from that mess, through their investment portfolios. And many insurers will undoubtedly face significant potentially adverse impact to their surplus positions as the financial crisis deepens; many of these companies have yet to fully quantify (or state publicly?) their exposure to underperforming mortgage and other asset-backed securities. From the insured's perspective, during this period of unprecedented upheaval in the financial sector, isn't it reasonable to assume that virtually all insurers have exposure they either aren't aware of or aren't yet owning up to? Is there really a "safe" market?

### Safeguarding Against Carrier Risk

There is no question that the current economic crisis has significantly increased "carrier risk" – that is, a carrier's financial risk (e.g., inability to pay claims, ratings downgrades), operational risk (e.g., surplus constraints, inability to raise capital to support operations, inability to retain key talent), and ownership risk (e.g., inability to maintain independence in the face of declining reserve position and market capitalization). Faced with enormous uncertainty and turmoil in the industry, what steps can brokers and insureds take to mitigate their exposure to carrier risk? First and foremost, brokers and insureds should maintain a healthy skepticism about the financial security of any insurer. If the current crisis has taught us anything, it's that apparently bullet-proof financials can morph into near insolvency virtually overnight.

Along with that skepticism, one concrete, easy and effective step brokers and insureds can take is to limit exposure to any one insurance carrier through syndication – that is, the utilization of multiple carriers (rather than just one or two) to build the necessary capacity for an insurance program. A well-designed, syndicated insurance program reduces the leverage and influence any single carrier has over the terms and conditions of the insurance program, and limits the insured's financial exposure to any single carrier who may be unwilling or, more importantly in the current economic crisis, unable to pay claims now or in the future. In a recent newspaper article about the life insurance industry, this kind of syndication was the preferred means to reduce the buyer's stress concerning long-term financial viability of insurance companies: "[I]f you want to be as close to safe as possible, said Francine Duke of Aqua Financial Planning in Lincolnshire, Ill., split your coverage between two companies in case one of them runs into trouble. 'It's like double locking your door,' she said. Or triple locking it if you need to work with three companies to put your mind at ease. Or sextuple locking it."<sup>2</sup>

The principal of spreading risk through syndication is equally valid for long-tail casualty lines. Without a real ability to say for certain



Utilizing multiple carriers  
builds in stability.

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which carrier(s) might be the next to fail, brokers and insureds should protect themselves by mitigating their carrier risk. Given the potential for continued adverse financial impact to the insurance industry, there simply is no “up-side” to placing all of an insured’s eggs in a single basket. Syndication really is the most sensible approach in this period of extreme financial doubt and uncertainty.

<sup>1</sup> Gretchen Morgenson, “Behind Insurer’s Crisis, Blind Eye to a Web of Risk,” New York Times, 27 September 2008.

<sup>2</sup> Ron Lieber, “What Happens When Your Insurer Goes Under?”, New York Times, 14 November 2008.

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IRONSHORE  
*your safe harbour*

IronHealth  
86 Hopmeadow Street, Third Floor  
Simsbury, CT 06070  
[www.IronHealth.com](http://www.IronHealth.com)