The Game of 'Pass the Risk': Then and Now

by Joy A. Schwartzman

Financial crises are nothing new. What is unique and sobering is the far greater speed with which the current situation has evolved from a weakening of the U.S. housing market into a full-blown, global economic meltdown. Also new this time is how quickly the fallout spread beyond the financial sector into all areas of the economy. Advanced communications and information technologies are creating an era of greater risk with more serious and far-reaching consequences when compared with even the recent past. The increased speed, complexity and interconnectedness of global markets today make them more vulnerable to correlated risks that can combine to magnify liability. These new time and impact factors must be included in any future risk analyses.

The desire to succeed and do well financially encourages most people to work harder—to be more creative, innovative and productive. But at what point does enlightened self-interest mutate into greed and reckless disregard? When does innovation cease to be about creating a competitive edge and start to become a tool for gaming the system?

Consider some past economic crises: The London Market Excess (LMX) spiral[1] that began to unwind in the late 1980s; the 1990s U.S. savings and loan scandal; or the more recent bursting of the Internet and housing bubbles. These financial debacles all began life as positive examples of innovation. Each was touted originally as a new and profitable way of conducting business. Each promised to bring benefits to all, but culminated instead in bringing economic ruin to many.

Are unwinding spirals and busting financial bubbles the price that must be paid for harnessing self-interest in pursuit of innovation and profit? Is it possible to create risk management or other safeguards that can successfully reward innovation and enlightened self-interest, and yet restrain it from boiling over into rampant greed?

These questions become more urgent in the wake of the current financial crisis for two reasons:

1. **The greater speed at which financial data travel around the world today.** New communications technologies have turned the investment world into a large and loud economic echo chamber—one that feeds on and multiplies its own exuberance or panic. The instantaneous transmission of both good and bad economic news creates a climate of hair-trigger reactions as traders in different markets buy or sell on the rumor of the day. These knee-jerk transactions are then turned immediately into new data that exponentially amplify the fallout from the initial event. In this way economic ripples quickly become market-swamping tidal waves.
2. **All markets, industries and economies are now truly connected.** The consequences of economic events are no longer confined to one region, industry or nation. The fallout from the LMX spiral was largely restricted to the U.K. reinsurance market. The savings and loan scandal stayed in the United States and was contained within the banking industry. The bursting of the Internet bubble was global in scope, but its effects were not felt much beyond those who either worked for or held stock in Internet start-ups. The current crisis, however, which began simply as a softening of the U.S. housing market, grew within an incredibly short span of time into a global financial meltdown that has brought down major banks and affected almost every industry in every country around the world.

In pursuit of understanding how this happened and

[1] The "LMX spiral" represents excess of loss reinsurance placed in the Lloyd's and London Market in the 1980s where reinsurers participated in different layers of the same exposures, often unknowingly. As claims were reported and reinsurance recoveries were triggered, losses worked their way through the "spiral," often passing back and forth through the same group of companies.

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how the environment for risk has changed in only a few decades, it is helpful to look at some of the similarities—and, more importantly, the differences—between the conditions that preceded and led to the aforementioned LMX spiral, and the collapse of the subprime residential-mortgage-backed-securities (RMBS) market that sparked the current financial crisis.

Collateralized debt obligations (CDOs) and other debt securitization products were touted as way of diluting the poison of toxic risk by mixing it in with good, investment-grade debt. But instead of the good credit risk making the bad credit risk harmless, the bad risk polluted and ultimately froze the entire credit market. The excess of loss (XL) contracts of the 1980s placed in the Lloyd's/London Market were seen initially as a way of spreading risk across a series of reinsurers with the financial capacity to carry it. Both strategies became instead vehicles for foisting severely underpriced, highly correlated risks onto others—transmitting and multiplying toxic risk, in the case of the subprime mortgage debacle, so that it proceeded to spread like an infecting virus throughout the entire financial system—or, in the case of the LMX spiral, spreading risk at price levels that ultimately became toxic to some reinsurers when losses materialized.

The LMX spiral developed in the 1980s, during a time of relative softness and quiet in the reinsurance market—there had been low frequency of major catastrophes since the 1960s, and it appeared that markets and home prices would only ever go in one direction—up. (Sound familiar?) To compensate for falling rates in a soft market, Lloyd's greatly expanded its use of London market excess of loss (LMX) policies. LMX policies reinsure the policies of another reinsurance company or syndicate in exchange for a share of the premium. LMX business was attractive because it was easy to administer, had low overhead, and the aggregating exposures could be off-loaded to other reinsurers. Adding to their popularity and quick growth, LMX deals also offered commissions to brokers as high as 10 percent, thereby making them an attractive sell for brokers (very much like subprime mortgages). With risk ostensibly low and commissions high, it seemed a bit like free money, just as low interest rates and ever-higher home prices appeared to be a license to make money during the recent housing boom.

The growing popularity of LMX deals coincided during the '80s with a period of expansion within Lloyd's, as it opened its doors for the first time in centuries to thousands more "Names" (individual investors), many of whom were unsophisticated when it came to the insurance industry. These newer Names were disproportionately shunted into syndicates with a heavy concentration of LMX policies.[2]

Problems developed when a series of huge losses incited an escalating spiral of claims that pinged back and forth among the finite number of companies and syndicates that had spent the past few years writing excess of loss protection for each other. There were huge losses related to the Piper Alpha oil platform explosion in the North Sea, the Exxon Valdez oil spill in Alaska, Hurricane Hugo, the San Francisco earthquake and a devastating windstorm in Europe. Any one of these events may have been enough to start the spiral unraveling; taken together they precipitated the greatest financial crisis in Lloyd's 300-year history. Lloyd's lost nearly 8 billion pounds between 1988 and 1992, many of the losses due to negligent underwriting, according to British courts.

The similarities between the LMX spiral and subprime RMBS debacles are many. In each case there was:

- An attempt to mitigate risk by spreading it to market participants
- A series of new and complicated financial instruments not understood by most people and not even well

[2] Along with asbestos exposures.

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understood by market professionals

- A pool of unsophisticated investors not adequately advised of the risk they were taking on
- A collection of unscrupulous brokers (reinsurance/mortgage) who took advantage of the situation to increase commissions by encouraging as many deals as possible with no concern as to how they might play out in the future
- Huge profits that continued as long as nothing happened to change the situation on the ground.

In the case of the LMX spiral, there were no issues as long as there were no catastrophic events to set off a series of back-and-forth claims among the finite number of reinsurers. In the over-heated RMBS market, everything was fine as long as housing prices continued to only go up.

The differences between the two crises sparked by the LMX spiral and the subprime meltdown are fewer and have more to do with how the two situations played out once the trouble began. They are also more important than the similarities for purposes of "lessons learned."

- The LMX spiral continues to play out, but has not spread to other areas of the financial system. There was time to digest what was happening and to respond in a manner that left the institution of Lloyd's and the London insurance market intact and at least functioning in its weakened state, despite the seriousness of the crisis and the depth of the damage caused by it.
- Lloyd's ultimately made good on its obligations and—with the creation of Equitas, a facility created to offload the unprofitable business years—returned to profitability. This cannot be said for Lehman Brothers, Bear Stearns or the many other banks, mortgage companies and unrelated businesses that have either failed, been sold or are teetering on the edge of insolvency in the wake of the subprime securitization meltdown.

Time is no longer on the side of today's financial institutions in a state of crisis. And markets are so globally interrelated today that the fallout from major financial problems can no longer be contained to one country or region of the world.

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