Creating an Exchange for Insurance Contracts

by Oakley E. (Lee) Van Slyke

Observations

As risk professionals, we know that managing leverage is the heart of risk management. Leveraged businesses naturally tend to use excessive leverage. We deal with regulations that exist in order to dampen the tendency among insurance companies to become overextended during the underwriting "soft market." We observed that hedge funds, investment banks and private equity funds used excessive leverage as the credit boom went on. We observed an attitude of *laissez faire* rather than a call for regulation.

As risk professionals, we know the importance of personal underwriting. During the credit boom, lenders did little or no personal underwriting. Lenders relied on credit ratings, especially on ratings of the packages of loans they were laying off to investors. The rating agencies in turn used technical measures of risk rather than evaluating each package of loans individually.

As risk professionals, we know the importance of managing leverage. Investment models that relied on ratings assumed that those ratings were bets on independent events. Actually, all the risk events were linked together. The ratings shared the same defects and were subject to a single point of failure. Investors and rating agencies failed to recognize the increasing risk of increasing leverage. In short, ratings failed to assess risk.

As risk professionals, we know that outcomes don't fit simple models. Indeed, our training suggests that all models are wrong, although some are useful. We appreciate the importance of using a variety of valuation approaches and selecting an estimate that makes sense in light of all of the results. When values must be set using algorithms, we encourage algorithms that blend the estimates of several models. We respect the importance of testing those models and calibrating them with actual data derived from many years' experience. We observed in the current crisis the banks placed excessive reliance on a single simple model, often called value at risk (VAR).

As risk professionals, we know that wise insurance regulation has often led to the merger of a poorly managed book of business into a well-managed company. Bankruptcy is seldom the best option. As risk professionals, we know also that regulations have a cost in terms of productivity and service. Most of this cost is borne by customers because it can't be passed on to shareholders. Customers also get most of the benefits of regulation, including solvency protection and better service. The best regulation provides enforceable contracts, criminalizes fraud and minimizes bad information.

Insurance contracts are living documents. Many are endorsed, renegotiated, cancelled mid-term or subject to audit. In the credit boom, on the other hand, despite the likelihood that at least thousands of subprime mortgages would default, lenders did not designate people or agencies to renegotiate the terms of loans. Foreclosure was the presumed outcome, and it became the only outcome even when foreclosure was not in the financial interest of the lenders.

No government commands all of the resources of the capital markets. Some governments such as Iceland and Switzerland have quite limited resources as lenders of last resort or investors in banks. As risk professionals, we appreciate the importance of engaging the world's capital markets, the more directly the better. The best solution is one that can be adopted globally.

As Steven Cecchetti, now the chief economist of the Bank for International Settlements, has pointed out, "The difference between futures and swaps is that futures are standardized and exchange-traded through a clearing house. This distinction explains why Amaranth's failure provoked a yawn, while LTCM's triggered a crisis. It suggests that regulators, finance ministries and central bankers should be pushing as many securities on to clearing house-based exchanges as possible. This should be the standard structure in financial markets."

As James Surowiecki, author of "The Wisdom of Crowds," has pointed out, the presence of a well-respected

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company on an exchange does not mean that that exchange is for every company. Companies that raise capital for non-financial activities by selling bonds and issuing stock are suitable candidates for listing on stock exchanges. However, companies that rely on or issue financial guarantees (such as investment banks and financial guarantors) take on additional risk when they issue stock because a general loss of investor confidence will reduce the fair market value of their assets at the same time that it reduces the willingness of investors to hold their stock.

That is, we are cautioned to use exchanges and to choose them wisely. At present there are only two kinds of exchanges in practice: securities exchanges and commodity futures contracts exchanges. Securities markets cope with rapid price changes, but are characterized by long-term price bubbles followed by bankruptcies. Commodities exchanges handle both asset positions and liability positions, but seize up when prices change quickly; many kinds of contracts which can be expected to have rapid price changes can't be placed on commodities exchanges.

The invisible hand of the market works in theory only when there is an active exchange between willing buyers and willing sellers. When there are willing buyers and willing sellers for goods and services, the invisible hand seems to work well in practice, too. The problem is not with the theory of the active market. The problem is that from time to time there are reasons that buyers buy against their will or sellers sell against their will, or that buyers are restrained from buying or sellers are restrained from selling.

The more the investors believe any one theory or explanation, the more they tend to move as a herd. In the recent bubble, accounting rules and the pressures on CFOs added particularly to the herd-like behavior. This always happens a bit. But in this case the change to "fair market value" accounting caught many CFOs without the training, experience or data processing capabilities to make intelligent estimates of fair market value. The default valuation has been "the last transaction," which has caused all CFOs to use the same estimate no matter how unwilling the buyer or seller. Accounting rules also had the effect of keeping a homogeneous class of contracts "off balance sheet" until, in the span of just a few months, the contracts became illiquid, at which point other accounting rules brought those contracts onto balance sheets.

Investors can move as a herd toward ever-higher asset prices even when a few investors attempt to turn against the herd. When a contrarian loses a bet, his loss both increases the wealth of the herd and justifies the herd's direction. As Keynes said to contrarians, the market can stay wrong longer than you can stay solvent.

Lessons Learned

Neither securities exchanges nor commodity futures exchanges were designed to deal with securitized derivative contracts. Securitization can be a good way to access the global capital markets, but only if the problems we've observed are successfully addressed.

These problems are:

1. Securitization must no longer be an impediment to the normal process of renegotiating contracts. Packages of contracts can be listed on a contracts exchange, but this should not preclude negotiations of changes in the underlying contracts.
2. There must be an abundant flow of transactions between willing buyers and willing sellers. Securitizations must be standardized and traded on exchanges. Every position should be carried on a balance sheet. Transparency is important, but "fair market value" does not help if there is no market that has willing buyers and willing sellers.
3. Prices on securities exchanges can change quickly without seizing up but can't go close to zero without inviting bankruptcy. Prices on commodities futures contracts exchanges can be "long" or "short" but can't

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change quickly. Both of these problems must be addressed at the same time.

Policy Implications

The system of using securities exchanges and commodity futures contract exchanges is inadequate to the task. Neither can transfer the risks of derivative financial contracts to the capital markets. Regardless of the degree of regulation or the financial incentives, this system is insufficient. A new type of exchange is needed that copes with fast price changes—even from "long" to "short"—without inviting bankruptcy.

A new type of exchange is needed. This new type of exchange would enable its traders to trade shares of standardized packages of financial contracts without margin accounts, position limits or daily price change limits. Those traders must be listed on a securities exchange so that the world's capital markets are able to invest in them. Regulations would be needed to prevent fraud and price manipulation, but not to prevent any trader's insolvency, as ease of entrance and exit must be built into the system.

Providers of insurance, financial guarantees and product warranties as well as derivative contracts of all kinds should be either highly regulated or listed on contracts exchanges that ensure transparency and liquidity, permit ease of entry and exit and collectively have the backing of the world's capital markets. Retail insurance companies are highly regulated. Reinsurance companies and syndicates could be listed on liquid contracts exchanges or be highly regulated.

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