What you don't know can hurt you

David Spiller draws some time-worn lessons from the subprime financial scandal.

David Spiller is president and chief executive of Guy Carpenter.

What do tainted toothpaste and the subprime mortgage market have in common? More than you might think.

The poisonous substance found in toothpaste in dozens of countries was not smuggled in under the radar to sweeten the taste. It was right there, listed alongside other ingredients on the label of the tube. Hiding in plain sight, it escaped the notice of government inspectors and health authorities around the world until it caught the eye of a 51-year-old consumer in Panama, a government worker who reviewed environmental reports and remembered the awful ingredient, commonly found in anti-freeze, from the high profile it gained when it killed or disabled dozens of his countrymen who ingested it in cold syrup.

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The discoverer, Eduardo Arias, told the *New York Times* that the potentially fatal ingredient jumped out so clearly on the label that he did not even have to touch the toothpaste tube displayed at a local discount store to read the words 'diethylene glycol'.

This staggering breakdown in risk management demonstrates the potentially lethal disconnect that can occur along the chain of those packaging a risk and those assuming it. This is especially true as the chain stretches and risks are repackaged in sometimes unrecognisable ways. We see it when one purchases a tube of seemingly-safe toothpaste… or invests in securities unaware of the risky mortgages ticking within.

Of the billions of dollars in mortgage loans issued by mortgage lenders or brokers before the housing bubble burst, many were passed along to commercial banks and securitised by investment banks before landing in the hands of unwitting investors.

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Now that the riskiness of many loans has been revealed, it's not those closest to the risk, the mortgage banks or lenders, feeling the worst sting. Mortgage makers and servicers can recoup some lost dollars charging fees in the foreclosure process. Investors that lost big have no such consolation.

Could something like this subprime debacle happen in reinsurance? In our business, risks are laid off in succession, from insured, to insurer, to reinsurer and — on rarer occasions these days — to the retrocession market. The process very much parallels the path of home mortgages. One cannot help but recall the LMX spiral, when there was a long chain from initial risk transfer to ultimate risk holder. In that case, one risk taker's North Atlantic hurricane risk was another's excess of loss property exposure. No one realised how fatally inbred it all was until a few catastrophic events collapsed the house of cards.

Working in favour for today's reinsurance world, the chain of risk assumption has shortened significantly, with the retrocessional market playing a much reduced role. Moreover, reinsurers (like insurers) now go to great lengths through modelling and analytics to be aware of the risks they are assuming and interconnections between them. In addition, the use of parametric triggers in transferring risk to reinsurers and/or capital markets greatly reduces the uncertainty in the risk assumption process.

Reinsurers even seem to be dodging the fire of subprime-related securities claims. Only time will tell what the full brunt of these claims for primary insurers will be but reinsurers can probably sleep easy. The directors' and officers' (D&O) reinsurance market is a fraction of what it was pre-Enron; the larger D&O carriers typically forgo reinsurance altogether.

Do surprises lurk in the catastrophe bond market? In fact, the catastrophe bond market could be the big winner in the subprime crisis. This market rose to the mainstream on the claim that its risks are uncorrelated with the overall financial market. It doesn't move with the global financial markets; it moves with the wind. Unengaged by subprime problems, it will prove its point. (Of course, if subprime tumbles ultimately trigger a worldwide financial crisis, sell off pressures could encompass practically all risky assets, including Cat bonds.)

All of this serves to underscore a fundamental premise of our business — of all businesses. What you don't know can hurt you. As consumers and as professionals, we must go into each transaction, with our eyes wide open. re

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