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Governing Kidnap for Ransom: Lloyd's as a "private regime"

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Abstract

Who orders economic transactions between the criminal and legal economy? Kidnap for ransom raises significant governance challenges. In the absence of formal regulation and enforcement insurers have created an effective private governance regime to facilitate smooth commercial resolutions. Controlling ransoms is paramount: "supernormal" profits for kidnappers create kidnapping booms and undermine the market for insurance. Ransom control requires cooperation, but there are high transactions costs in enforcing a collusive agreement. Coase therefore predicts that a single firm will form to internalize the externalities arising from lax insurance and mismanaged ransom negotiations. Indeed, the vast majority of kidnap insurance is underwritten by and reinsured through Lloyd's of London, which essentially functions as a club providing private governance. Within the Lloyd's market several insurers compete for business, but all issue standard contracts, follow the same regime for kidnap resolution and exchange information to stabilize ransoms.

1: Introduction

This paper studies governance at the ragged intersection between the legal and illegal economies: the regime ordering kidnap for ransom. Kidnapping is a major (if largely hidden) criminal market. Industry experts estimate that there are around 40,000¹ - 100,000² kidnaps and an estimated total turnover of between US\$500mn³ and US\$1.5bn⁴ a year. Ransoming hostages is beset with trust and enforcement problems. Kidnappers want to maximize ransoms and can employ extreme violence to pressurize families to reveal their assets. Families and law enforcement may prepare rescue operations while pretending to negotiate a ransom. The payment process is problematic: ransom drops can fail even if both parties act in good faith. Kidnappers need not release (live) hostages after payment and may demand multiple ransoms (Clutterbuck 1987, March 1988, Lopez 2011). Despite these considerable difficulties, ransoming succeeds in the vast majority of cases.

Reliable and orderly commercial resolutions underpin the rising global demand for kidnap insurance (Kenney 2007/08, Fink and Pingle 2014, The Economist 2013). This paper argues that insurers facilitate smooth kidnap resolutions to underpin the market for kidnap insurance. However, it is not enough to order individual transactions on behalf of the insured. Premium ransom payments (while individually rational) have the potential for destabilising the market for kidnap for ransom insurance. This externality needs to be internalized. Cosean

¹ Catlins 2012

² Agenda Week 2012

³ Foreign Policy Centre 2001; The Economist 2013; Catlins 2012

⁴ Independent, October 17, 2010

reasoning and club theory are used to analyse how competing insurers co-operate to provide effective governance in this criminal market (Coase 1960, Stringham 2015).

Kidnap for ransom has become increasingly politicized as terrorist groups regularly obtain multi-million dollar ransoms from governments which nominally follow no-negotiation strategies (NYT 2014, United Nations 2013). Governments have a duty to ensure the safety of their citizens. Yet, they must balance the human security of hostages versus broader security aims, which are undermined by paying large ransoms to organisations such as ISIL/Daesh and Al-Qaeda (White House Briefing 2015). This paper examines how private insurers order transactions and maintain ransom discipline in “criminal” kidnap for ransom.⁵ Detailed knowledge of how private governance operates effectively across the legal / illegal divide is highly relevant to policy formation regarding the payment of ransoms to terrorist organizations (Sandler et al 2015, Wall Street Journal 2015, White House Briefing 2015).

There is already a large literature on private and self-governance in political science and related disciplines. Private solutions to facilitate trade are common where government and law enforcement are absent or uninterested in protecting private property rights, or the legal process is too expensive or unsophisticated to resolve disputes (Stringham 2015, Williamson 1996). On the one hand, there is the study of private governance solutions for (broadly) legal trades and joint enterprises. Cutler et al (1999a) provides an overview of a wide range of private governance regimes, where experts or firms cooperate to order and facilitate international and online transactions. Governments can only enforce laws domestically and agents creating effective private governance regimes reap the gains of

⁵ For “criminal” kidnaps the ransom can be insured, whereas in “terrorist” kidnaps paying and reimbursing ransoms is illegal.

greater efficiency or market dominance (Stringham 2015). Greif (1989), Leeson (2006, 2011), Munger (2010) and Stringham (2015) study historical situations, where effective and sophisticated institutions incentivized co-operation long before governments began to regulate, legislate, adjudicate and enforce. The predominant strategy is to create a credible threat of excluding opportunistic and rogue traders from future transactions – or at least significantly reducing their profits from doing so. On the other hand, there is the literature on the governance of criminal markets (see Varese 2014 for a review). In the grey and illegal economy the protection of property rights and contract enforcement is delivered by *Mafias*, prison gangs or armed militias (e.g. Gambetta 1993, Leeson and Rogers 2009, Shortland and Varese 2015, Skarbek 2014, Varese 2001). Here the credible threat of violence against rogue traders (largely) keeps opportunism in check.

The ordering of trades straddling the divide between the criminal and the formal economy has not been analysed so far. Stolen assets may be valued much more highly by the original owners than their criminal market value – e.g. hostages, hijacked ships and famous art. Trade between criminals and original owners may thus be pareto-optimal and insurers may have an economic interest in ordering such trades. A sophisticated insurance industry has developed in response to the risk of transnational kidnaps – related to the “political risk” insurance which underpins much of global commerce Haufler (1997, 1999).⁶ Risk-averse families, NGOs and firms employing staff in complex and hostile environments often buy insurance to help resolve and defray the cost of resolving criminal kidnaps (Lobo-Guerrero 2007, Kenney 2007/08, Fink and Pingle 2014).⁷ Kidnap insurance is only economically viable

⁶ There is also a “local” kidnap market, which is ordered by local providers of informal governance – see for example Safer Yemen 2014.

⁷Block and Tinsley (2008) and UN (2013) discuss why ransom payments are not usually outlawed altogether.

under three conditions. Firstly, kidnaps should be rare, detentions short and violence minimal - otherwise individuals and firms withdraw from high risk areas (Pshisva and Suarez 2010, Rodriguez and Villa 2012). Secondly, insurance premia must be affordable or people opt out of insurance. Thirdly, ransoms and kidnap volumes must be predictable and premium income must cover (expected) losses (Haufler 2009). If kidnapping generates supernormal profits, more criminals enter the kidnap business. Premium ransoms can quickly generate kidnapping booms (Hagedorn Auerbach 1998, Sandler et al 2015, UN 2013, Wright 2009). Insurers therefore have a common interest in ordering transactions and preventing ransom inflation.

Where governance is provided privately by competing firms or agents, different market structures and degrees of institutionalisation have been observed (Cutler et al 1999b, Haufler 1999, Stringham 2015). What institutions help kidnap for ransom insurers cooperate? The transaction cost literature adopts a contractual approach to the study of economic organisations (Williamson 1989). It posits that the observed market structure arises because it minimizes transaction costs (Williamson 2002). Coasean reasoning applies, because there is a market failure at the heart of this co-ordination problem (Coase 1960, 2012): impatience and badly managed ransom negotiations give rise to externalities. Containing ransom payments is expensive: offering a high ransom can result in a faster release, reducing negotiation costs and risks for the hostage (Ambrus *et al* 2014). But high returns to kidnapping may trigger a kidnapping boom and ever-rising ransom demands. Unlike other insurance markets, kidnap insurers cannot individually establish reputations for low settlements: revealing their presence in negotiations raises kidnapper expectations (March 1988). Premium ransoms thus create externalities borne by all market participants. Insurers must cooperate to control prices.

Although there is no “market” in ransoming – each kidnapper deals with stakeholders linked to a single insurer – co-operation between insurers is akin to forming a buyers’ cartel setting maximum prices for hostages. Indeed, “ransoming cartels” were formed to negotiate prisoner of war releases in the 17th and 18th centuries (Frey and Buhofer 1988). However, in kidnap for ransom insurance contracts between insurers to limit ransoms would be unenforceable. It would be very costly to prove that a high ransom was paid because an insurer cut corners, leaving a cartel agreement vulnerable to “chiselling”. Coase (1960) predicts that the most efficient market structure is a single firm, which fully internalizes the externality.

Indeed, a closer look at the market for kidnap insurance reveals that kidnap insurance is controlled by a single firm: Lloyd’s of London. Within Lloyd’s there are around 20 syndicates underwriting kidnap for ransom insurance (though their products are available through many more outlets). The syndicates compete for business according to clear protocols regarding how insurance contracts are structured, how information is (discreetly) exchanged and how ransom negotiations are conducted. Lloyd’s is a “private regime” in the sense of Cutler et al (1999b, p13): a complex set of formal and informal institutions that provides the governance for a specific economic issue area. As the necessary rules and protocols cannot be easily codified and enforced through the legal system, Lloyd’s still operates as a “club” for the provision of private governance (Stringham 2015). This solves the externalities problem while facilitating competition between insurers. Furthermore, Lloyd’s syndicates voraciously internalize externalities – including those arising from uninsured risks - to make kidnap for ransom insurable. It is a perfect example of the way in which externalities and transactions costs shape the institutions which make up the economic system (Coase 2012 p13).

The paper also contributes to the literature on the insurability of risks. Fink and Pingle (2014) and Kenney (2007/08) examine the decision to buy kidnap insurance, but not how insurers can profitably supply it. Haufler (1997, 1999) and Cutler et al (1999b) point to the role of underwriters in setting standards for what can and cannot be insured. Avant and Haufler (2012 p20) draw attention to the plethora of private security companies and risk analysts which offer risk mitigation services. Lobo-Guerrero (2007) discusses the security audits required to make kidnap risks insurable. To the best of my knowledge nobody has studied how multiple insurers collaborate to stabilize kidnaps and ransoms at a level where kidnapping is profitable to insure.

Specialty insurance and kidnap resolution are by necessity discreet operations. If firms or individuals are known to have insurance, moral hazard problems arise, kidnappers might target insured individuals specifically and their ransoms expectations escalate (March 1988, Ochoa 2012). Specialty insurance is mostly “bespoke”: prices vary according to who is insured, for what purposes, the number of people exposed to risk, the risk environment, risk mitigation measures, previous incidents *etc* (Lobo-Guerrero 2007, Merklings and Davis 2001). This secrecy makes it infeasible to collect representative, quantitative data on who buys insurance from whom and at what price. Most of the evidence presented below is open source information from insurance companies and the Lloyd’s corporation. Some ransom data were provided by the business risk consultancy Control Risks. In addition I conducted sixteen in-depth interviews of 1-3 hours with employees of different crisis response companies, victims, insurers and lawyers involved in kidnap resolution – see appendix A for details. Several individuals agreed to be re-interviewed or provided additional information by e-mail as the project took shape, allowing me to cross-check information and confirm the

validity of my findings. As most informants chose to remain anonymous I used secondary open source information from the insurance sector, crisis response companies, governments, NGOs, memoirs of ransom negotiators and newspaper articles to cross-reference the interview information where possible.

2. Ransom discipline

Contrary to general perceptions based on newspaper headlines, most commercially resolved kidnap cases conclude relatively cheaply and quickly. Catlins – a major underwriter of kidnap risks - reports that *“In land-based kidnapping... the ransom amounts are comparatively small... Most demands are in the thousands or tens of thousands of dollars. Only a few cross the six-figure threshold, and still fewer exceed US\$1 million.”* (Catlins 2012, p2) Data from the business risk consultancy Control Risks corroborate this assessment.⁸ Control Risks was involved in resolving more than 200 Nigerian kidnap cases in 2006-2014. The median duration was 5 days and 75% of cases were resolved within 10 days.⁹ Only one victim was detained for more than 50 days. Although these cases were resolved by Control Risks – suggesting that the targets were valuable – the median ransom per person was less than \$5,500 and 75% of cases were resolved for \$12,800 per person or less. Even for cases involving foreign nationals the 75th percentile is below \$100,000. Victim stakeholders – likely to include major oil

⁸ Control Risks is retained by Hiscox, the world’s largest underwriter of kidnap risks with a market share in of 60-70% by premium income in 2011.

http://www.hiscox.co.uk/html_emails/group/kidnap_ransom/docs/monthly_kidnap_news_0811.pdf

⁹ Oceans Beyond Piracy (2012, p16) reported average detention periods of around 4 days for piratical kidnap cases in the Niger Delta.

companies¹⁰ - never paid close to US\$1million. In Mexico (with a GDP per capita roughly three times that of Nigeria), Control Risks reports higher ransoms for more than a hundred kidnap cases between 2008 and 2014: the median ransom was \$37,565 and the 75th percentile at \$137,700. The median duration was 3 days and 75% of cases were resolved within 5 days. Just two cases settled for more than \$1 million.

Managing and containing the expectations of kidnappers is essential. Kidnap insurance needs to be reasonably priced and detentions short. If kidnappers' ransom expectations are stable and affordable, negotiations converge rapidly and insurance works well. Ransoms are negotiated under asymmetric information: kidnappers do not know who pays the ransom (family, firm, insurer or government) – or the financial position of each of these entities. This is very different from the efficient plunder contracts observed by Leeson and Nowrasteh (2011), where the approximate market value of ships and cargoes was common knowledge.¹¹ In the absence of detailed information, kidnappers appear to base their ransom expectations for specific “victim types” on easily verifiable characteristics and past ransoms for that “type”.¹² Interviews with professional ransom negotiators and victim stakeholders indicate that for most negotiations the “target settlement price” and negotiation duration are fairly clear from the outset (Interviews IV, V, X, XI, XIII, XIV, March 1988).

¹⁰ Shell, ExxonMobil, Chevron, Total and Eni account for 90% of total Nigerian crude output. *Petroleum Review* (2013)

¹¹ Rich, well-known families often pay high ransoms very quickly, as their financial position is known to the kidnappers. This does not necessarily affect ransoms for other victims.

¹² In Frey and Buhofer (1988) ransoms were negotiated according to soldiers' (easily observable) rank. Somali pirates priced according to ship type, size, flag state, crew numbers and nationalities (World Bank 2013).

However, if kidnapers receive an outlier ransom, concurrent and future victims of that type are also tested at the new price (Interviews II, IV and V). News of large, easy ransoms – i.e. supernormal profits – quickly spread through criminal communities. New gangs enter the market modelling their expectations on previously realized ransoms. A badly conducted ransom negotiation is therefore not just problematic for the insurer who reimburses the inflated ransom, but for the wider industry.

A good illustration of a badly governed kidnap market is the evolution of hijack frequency and ransoms in Somalia (Figure 1). Initially, few ships had hijack-for-ransom insurance. Therefore, some ransoms were negotiated by myopic or inexperienced negotiators (including governments), who occasionally agreed record ransoms. These ransoms revealed valuable information about what Western ship owners would pay to retrieve their ships and crew. This led to a collapse of price discipline and the explosion of piracy.

- Insert Figure 1 here -

Somali pirates directly referred to a “market price” in their negotiations - meaning the price for recently released comparable ships. If news of a premium ransom arrived, this was included in ongoing and subsequent negotiations as the new “market price” (Interviews II, V, X, XI). As one pirate communicator¹³ explained to his counterparty:

“There are some ships like [name withheld], they went back, they are at 1.5 [million US\$] now 1.7, and then 4 or 5 days ago another third ship got 1.8. Those are the kind of stuff they are looking at, so what I am saying is... it’s my opinion because

¹³ Usually both sides nominate “communicators” to relay information between decision-makers.

these people they just like children you know. If you got that candy they want to have the same candy.”¹⁴

Ship-owners who resisted the new “market price” had their ships held for several further months (and sometimes years) to test their resolve. Ship-owners rarely managed to barter pirates down from their new target (Interview VI). Instead, they generally accepted the previous comparable settlement as the new reference value. As one ship-owner explained to the pirate communicator: “... *We can’t go above the current market*”. “*The [name withheld] is very similar to our ship. Ok, so ah, why do we have to go through this nonsense when they know the [name withheld] was done at 1.7? Why do I have to waste my time at 1.9?*”¹⁵ Econometrically, the best predictor of ransoms was the previous highest ransom paid for a particular ship type (De Groot et al 2012).

Premium ransoms can even influence cases in other geographic areas. NYT (2014) suggests that Al Qaida developed a common kidnapping protocol for the Islamic Maghreb, the Arabian Peninsula and Somalia and that while “...*in 2003 the kidnapers received around \$200,000 per hostage, now they are netting up to \$10 million*”. Each case therefore has the potential of creating significant spill-overs: there is an externality in overpaying kidnapers. On one level, this is a simple “pecuniary externality”, where an agent’s transaction changes prices for unrelated third parties. Mostly pecuniary externalities do not produce social costs, but transfer surplus between the counterparties of subsequent trades (Holcombe and Sobel 2001). However, in this case there is a social cost: the “products” in question are hostages – some of whom die in the “production process” - the “producers” are criminals and the “trade”

¹⁴ FBI transcript of CEC Future ransom negotiation: hijacked 7 October 2008, released 15 January 2009

¹⁵ FBI transcript of CEC Future

is a forced transaction. If criminals under-price their “product”, it would be hard to make an economic efficiency argument to reveal that information. Any new equilibrium involves higher transfers to criminals and consequently higher crime rates.

Moreover, if ransoms and kidnaps escalate insurance markets can collapse, imposing further social costs. As insurance premia rise, some potential victims will be priced out of buying insurance or only insure partially (Haufler 2009).¹⁶ If stakeholders are unable to afford the kidnappers’ target ransom, they have to wait until the kidnappers adjust their expectations downwards (or come under external pressure to release).¹⁷ Ambrus et al (2014 p2) argue that poor stakeholders signal their low valuation of the hostage by being patient – even when faced with physical violence to the hostage (e.g. NYT 1998). This signal would not be emulated by rich stakeholders. If everyone pays their reservation price, negotiations drag on as kidnappers probe stakeholders’ valuation of the hostage – with threats and actual violence.

In such cases people change their behaviour. Rather than insuring their usual activities for a rapidly rising insurance premium, they avoid the high risk area and disinvest (Pshisva and Suarez 2010), generating further economic inefficiencies and costs. Merklings and Davis (2001) report several insurers withdrawing from insuring kidnaps in Colombia at the height of the kidnapping boom. Ransom inflation and extreme detention periods also ended piracy in Somalia.¹⁸ Most insurers incurred heavy losses on their hijack for ransom policies and some withdrew from underwriting these risks (House of Commons 2012 Ev3). The remainder

¹⁶ The Guardian 2014 discusses recent developments in kidnap insurance premia.

¹⁷ In Fink and Pingle’s (2014) model the kidnappers simply kill poorer hostages – in practice murder is rare.

¹⁸ The last merchant vessel was taken in May 2012.

lobbied for naval protection and compelled ship-owners to adopt best management practice and employ private security guards (Shortland 2015). However, the cost of containment vastly exceeds the pre-2008 cost of insuring ships and resolving the very occasional hijack for much less than US\$1mn.¹⁹ Managing externalities is therefore crucial for kidnap for ransom insurers – and highly desirable from a public policy point of view.

3. Internalising Externalities

Containing ransoms requires potentially lengthy bargaining with kidnappers while managing relations with the media, police and relevant victim stakeholders. The process is usually led by a crisis management team of senior executives with the support of specialist consultants. Bargaining generally involves threats of violence and offers and demands may converge quite slowly - occasionally over periods of weeks and months (Clutterbuck 1987, Lopez 2011, March 1988). Given the high financial and psychological costs of negotiating, there is a temptation for hostage stakeholders to settle early and expensively. Insurers which regularly reimburse (falsely or negligently) inflated claims have to charge higher premia and eventually price themselves out of business. Normally, other insurers can take a tough line on inflated claims and hence remain unaffected by their competitors' mistakes. However, in kidnap cases the knowledge that victims are insured raises kidnappers' ransom expectations. The insurers therefore do not reveal themselves in the negotiation.²⁰ Insurers taking a

¹⁹ The cost of Somali piracy in 2013 was estimated at \$3-3.2bn with around \$2bn spent on military operations and on-board security teams. http://oceansbeyondpiracy.org/sites/default/files/attachments/SoP2013-2PagerDigital_0.pdf

²⁰ Firms invalidate their insurance cover if they tell employees that they are insured (Lobo-Guerrero 2007).

“tough” stance on ransoms would not be credible either. Kidnappers could blackmail insurers with violence and damaging media exposure – inviting litigation by hostage stakeholders.²¹ Insurers cannot therefore unilaterally prevent spill-overs.

An alternative would be for insurers to formally collude – i.e. form a buyers’ cartel to control ransoms. A buyers’ cartel aims to act as a monopsonist, extracting seller surplus. In kidnap for ransom there is no “market” for hostages: victims buy insurance before the kidnap, so just one insurer is involved in each transaction.²² However, the existence of the pecuniary externality motivates the formation of a “cartel”. Can insurers enforce a cartel agreement to internalize the externality? Coase (1960) argued that externalities are managed efficiently by the market if property rights are clearly assigned. If transaction costs are zero, it does not matter which party holds the property right: either the party which is harmed can pay the producer of the externality to desist from or reduce the harmful activity, or the producer compensates those harmed by its activities (Allen 2002 p5). However, if one wanted to contract over ransoms, transactions costs would be high. Firstly, the insurer does not “own” the hostages.²³ The negotiation is conducted by the insured’s family or firm: all decisions are made by the victim stakeholders in the perceived best interest of the victim. The insurer can only limit the amount of insurance cover and act in an advisory capacity.

Secondly, there are high information costs in verifying whether a “premium” ransom was paid. Allen (2002 p14) points out that acquiring information is costly when outcomes are both variable (by nature) and alterable (by man). Ransoms are highly variable (see figure 2).

²¹ See for example the political fallout from the ISIL beheadings (Wall Street Journal 2015).

²² Large contracts are sometimes underwritten by several syndicates, but there is a lead syndicate.

²³ Unlike Frey and Buhofer’s government-led ransom cartels in the 17th and 18th century.

Ransoms depend on the victim's financial position, the negotiating stakeholders' patience and personality and the sophistication and expectations of the kidnapping gang. But ransoms also depend on the effort of the insurer to steer the negotiation towards the appropriate settlement for the victim type and prevent an early, higher than desirable conclusion.

- Insert Figure 2 here -

If an outcome is both variable and alterable, cheating can occur without detection. Insurer "effort" in the ransom negotiation is not observable without full access to all aspects of the negotiation and briefings - plus detailed information on the victim's financial position and the kidnappers' sophistication. Kidnap victims would resist making this material public. Contracting between insurers is therefore neither enforceable nor self-enforcing (Williamson 2002). Myopic insurers could cut short ransom negotiations to save themselves time, hassle and cost and reimburse high ransoms without punishment.

As transactions costs are high, we must look for the most efficient assignment of the property right which confers externalities on others: underwriting the insurance contract. Coase (1960 p16/17) predicted that in the presence of high transactions costs the externality will be completely internalized by one firm owning all the activities that have external effects on each other. The most efficient market structure from a transactions cost economics point of view is therefore that one insurer "owns" all the kidnap risk (Williamson 2002).

H1: The most efficient market structure is a single firm selling kidnap for ransom insurance.

We should also observe that the firm is concerned about externalities arising from uninsured risks. It is in the interest of the insurer to insure cash-rich firms and families or otherwise prevent premium ransom payments by inexperienced or myopic negotiators.

H2: Companies and families which might confer externalities are incentivized to buy kidnap insurance or use professional risk mitigation and kidnap solutions.

Occasionally, people without insurance are kidnapped. Without advice about true local ransom expectations and faced with the threat of violence to their loved one, stakeholders might well offer their true reservation price to kidnappers. This could change kidnappers' expectations and thereby confer externalities on kidnap insurers and future victims. One would therefore expect insurers to provide advice on a "*pro bono*" basis – though the family will still have to pay the ransom.²⁴

H3: Insurers will provide free advice on uninsured cases which could confer externalities on the sector.

4. Evidence

4.1. "A single enterprise orders the market"

Prima facie the evidence for Coase is weak: the kidnap insurance market appears highly competitive. A large number of insurance companies, boutique insurers and brokers

²⁴ Not every uninsured person is offered *pro bono* advice, which is also perceived to be inferior to the "insured" service (Interview XV, March 1988). This reduces the incentive to free-ride.

sell kidnap insurance. But on closer inspection, the risk is borne by a much smaller number of “specialty risk” insurance companies. When large insurance companies actively market kidnap insurance, they usually do not offer an “in-house” product, but sell products from specialist insurers.²⁵ For example, both Zurich and Schinnerer sell Hiscox insurance.²⁶

Several major insurers do not advertise kidnap insurance at all (e.g. Allianz), but as a “one stop shop” will provide cover for their corporate and high net worth clients. Usually this is arranged through a broker, as general insurers do not have the necessary information to price a kidnap for ransom product correctly. If they do issue kidnap insurance – e.g. one might include “free” kidnap cover in a bigger insurance package - they usually reinsure 60-90% of the risks, rather than keeping this concentrated risk on their books (Interview XIV, XVI). Lloyd’s is a major reinsurance market: any significant business written on a direct insurance basis has a reasonable chance of being reinsured or retroceded back into the Lloyd’s Market (Interview XVI). This is especially the case for “specialist” kidnap insurance. Although the London market is only the fourth largest reinsurance market in the world, it is *“the leading market for companies that need[...] (re)insurance coverage for large, complex or bespoke risks.”* (London Market Group 2014 p8). As reinsurers, Lloyds specialty insurers take on the role of coordination services firms, setting standards for how this type of risk is insured (Cutler et al 1999b, Haufler 1999).

²⁵ E.g. Aon sells kidnap insurance “from a wide range of insurers for the broadest choice of price, coverage and response consultants” <http://www.aon.com/risk-services/crisis-management/kidnap-ransom.jsp>

²⁶ <http://www.zurichna.com/internet/zna/SiteCollectionDocuments/en/Products/directorsandofficers/MSG%20Kidnap%20and%20Ransom%20FS.pdf> and <https://www.schinnerer.com/industries/kidnap-ransom/Documents/KandR-Advantages.pdf> accessed May 2015

The setting of standards still requires coordination between the specialty insurers. The interviewees in this project named all the kidnap insurers they had ever used, worked for or had knowledge of.²⁷ Table 1 alphabetically lists the insurers mentioned.²⁸ The large majority of kidnap insurance policies are underwritten by Hiscox, AIG, Chubb, Travelers, XL/Catlin and Houston Casualty. The others are relatively minor players (Interview XIII).

All the insurers and brokers state on their websites who underwrites their kidnap insurance contracts. In all but one case, the companies referred either to Lloyd's generally or to a specific syndicate (or syndicates) within Lloyd's, where each syndicate is known by a unique number. Where the information was not precise I used the list published by the Bank of England of Lloyd's managing agents and syndicates to check how exactly the insurers were linked to Lloyd's. The list from 01 January 2015²⁹ showed that – with one exception discussed in detail below - kidnapping risks are either underwritten by specific Lloyd's syndicates, or are likely to be placed in the Lloyd's market through Lloyd's brokers.

The exception to the rule appeared to be American International Group – named above as a major underwriter by industry insiders. AIG does not advertise or mention a Lloyd's connection on its website and no Lloyd's syndicate is registered with the AIG brand name. However, the annual statement of syndicate 1414 "Ascot Underwriting Limited" states:

²⁷ There are additional brokers of kidnap insurance (e.g. A J Gallagher), but they sell unmodified cover from specialized insurers.

²⁸ The market is fluid with occasional mergers, entries and exits. The table reflects the *status quo* in July 2015.

²⁹ 2015 list available through Google. The previous year's list has the following web address

<http://www.bankofengland.co.uk/prd/Documents/authorisations/syndicateslist1401.pdf>

“The only related parties that have transacted with Syndicate 1414 are companies within the AIG group of companies.” (p21) and “The ultimate parent company and controlling party of the Syndicate’s main corporate member, ACNL, is American International Group Inc. (“AIG”) ...” (p22).³⁰

There are no kidnap insurance products marketed directly by Ascot. AIG clearly does not value the Lloyd’s brand and yet underwrites insurance at Lloyd’s via Ascot. Coase’s explanation would be that as an outsider AIG would not be trusted to internalize the externalities. By incurring the considerable cost of maintaining a syndicate at Lloyd’s, AIG signals that it is invested in kidnap insurance in the long term.³¹ This is analogous to patient traders in informal economies making valuable gifts to local chieftains to distinguish themselves from opportunistic traders (Leeson 2006). In addition, as an insider AIG is able to access relevant case information. There is therefore clear evidence in favour of Coase’s prediction of a “single firm” solution to the externalities problem in kidnap for ransom insurance. How do they collaborate to control ransom inflation?

4.1.2. Insurance at Lloyd’s

Lloyd’s (formerly Lloyd’s of London) is not an insurance company *per se*, but a market. Lloyd’s members (individual “Names”, limited partnerships or corporations) can join together as a syndicate and provide the capital supporting the syndicate’s underwriting business. Legally, the membership in a syndicate lasts only for one year at a time. Most syndicates’ core

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<https://www.Lloyd’s.com/~media/files/Lloyd’s/investor%20relations/syndicate%20reports%20and%20accounts/2013/1414a.pdf>

³¹ See Economist 2004 on the cost of joining Lloyd’s.

capital is provided by the same members for many years and syndicates function as permanent insurance operations.³² Transactions are conducted face-to-face in the Underwriting Room between the underwriters and the Lloyd's Brokers.³³ The brokers are highly specialized in particular areas of risk. They negotiate competitive terms for their clients within the market, with different syndicates competing for business.

- Insert Figure 3 here -

Figure 3 shows the lay-out of "underwriting boxes" in the ground floor of the Lloyd's building in Lime Street.³⁴ The "boxes" are desks shared by 4-8 specialist underwriters, who are approached by brokers for quotes regarding particular risk exposures. Most syndicates offering kidnap insurance are located in this area, with the exception of Houston Casualty on Gallery 1, Aspen on Gallery 2 and CV Starr and Chubb on Gallery 3.³⁵ Each syndicate has one or two kidnap specialists, who develop great expertise and occasionally move between companies (Interview XVI).

In this small community information can flow without compromising client confidentiality. The Economist (2004) cites Mr Hiscox of the eponymous underwriting business about the Lloyd's market: "*...we all see each other's risks... It's wonderfully gossipy.*" Underwriters discuss ransoms paid, negotiation durations and the performance of crisis

³² <https://www.Lloyd's.com/Lloyd's/about-us/what-is-Lloyd's>

³³ The Lloyd's market can also be accessed through "coverholders", who are authorized to enter into insurance contracts on behalf of a syndicate.

³⁴ The major underwriters are highlighted. Beazley, QBE Marine, ACE, Canopus, Ironshore (Pembroke) and Liberty are also in the room. XL and Catlin merged since publication of the guide and their boxes were labelled XL/Catlin in June 2015.

³⁵ New syndicates are given a desk where one becomes available (Interview V).

response consultants “*over lunch*” (Interview V). This information flow is crucial to the functioning of the market. To price their product and conduct efficient ransom negotiations insurers need information of relevant past cases. However, most kidnaps are resolved very discreetly. Families and firms rarely wish to advertise how much they paid a kidnapper - even if there are no legal issues surrounding abetting crime by paying a ransom.³⁶ Open source information is therefore scant and unreliable.³⁷ Significant under-reporting of cases is the norm and where ransoms are released the information is often contradictory. The availability of information within Lloyd’s and the high cost of acquiring it outside creates a significant barrier to entry into the market.³⁸

The Lloyd’s corporation sets the framework and rules under which the syndicates compete – it is a “private regime”. Although independent, all syndicates operate according to Lloyd’s by-laws. The Corporation of Lloyd’s oversees and governs the market and sets the required capital levels for its members. It also sets commercial standards to ensure that “*underwriters operate in a way that benefits the whole market.*”³⁹ The Corporation holds the syndicates’ assets and members’ funds in trust, so they are available to cover the insured risks. To cover catastrophic losses exceeding the funds of individual syndicates there is the

³⁶ Some countries attempted to outlaw ransom payments – see Block and Tinsley 2008.

³⁷ The Guardian 2014

³⁸ This does not mean that it is never attempted. The House of Commons Select Committee (2012 Ev3) shows that boutique insurers attempted to enter the Somali hijack for ransom insurance business. However, they found it unprofitable and had stopped providing coverage by 2011. Headhunting key staff may be another way to get the necessary information. In 2012 an Australian insurer employed the former global manager of kidnap insurance from Chartis (AIG) to head its (tiny) kidnap for ransom division. However, updating information without a Lloyd’s connection would be difficult and it is likely that the products are reinsured at Lloyd’s.

https://www.acchealth.com.au/product_special_risks.do

³⁹ HMRC Introduction to Lloyd’s <http://www.hmrc.gov.uk/manuals/lmanual/LLM1010.htm>

“Central Fund” – consisting of mutual assets held by the Corporation and the ability to call on all members to make additional subscriptions if needed. This fund can be used to meet any member’s insurance liabilities. Lloyd’s strong international credit rating – often referenced by the insurers - is based on this “Chain of Security”.⁴⁰

Syndicates trading under the Lloyd’s brand therefore benefit from and contribute to Lloyd’s central resources. The Lloyd’s brand and its credit rating are extremely valuable – especially to the smaller insurers. In return, syndicates operate under the Council’s watchful eye: *“... the Corporation reviews and agrees business plans, monitors compliance against Lloyd’s minimum standards and monitors syndicates’ performance ... Lloyd’s can take a range of actions, including, as a last resort, requiring a syndicate to cease underwriting.”*⁴¹

The wording here (and elsewhere) seems surprisingly vague: what exactly is a transgression against “*minimum standards*”? The lack of strict criteria is the very strength of Lloyd’s, which effectively still operates as a “private club” (Stringham 2015). Under its by-laws Lloyd’s can exclude syndicates which destabilize the market without hard evidence of malpractice. Club membership has a high value in terms of access to crucial information and the financial guarantee. Members are unlikely to risk this in pursuit of short-term profits. Indeed, in practice the “Corporation” usually only intervenes in the “Market” to provide guidance and information (Interview XVI). The Lloyd’s set-up of “Corporation” and “Market” therefore enables both cooperation (to control ransoms) and competition (for business). So what are the (implicit) rules of “good practice” in kidnap for ransom insurance?

⁴⁰ Lloyd’s Annual Report 2011

⁴¹ Lloyd’s Annual Report 2011 p8

4.1.3. The Lloyd's "regime" for kidnap insurance and resolution

Kidnap insurance is usually "bespoke": the insurance premium depends on the risk exposure and the mitigation practices adopted by the company or family (Lobo-Guerrero 2007). Part of the insurance premium is used for security briefings, staff training and security checks on premises (Business Insurance 2008). The insurance contracts are extremely similar in the coverage they provide and in their approach to resolving incidents (Marsh 2011, Interviews III, IV, V).⁴² The maximum ransom which can be insured is limited to what the client (corporate or family) can raise themselves. The ransom is reimbursed after payment and the insurance contract cannot be used as collateral – meaning the victim stakeholders actually have to raise the ransom themselves initially. Employers are not allowed to discuss the insurance with their employees – doing so will invalidate the insurance cover.⁴³ All these stipulations serve to reduce moral hazard among the insured.

In the event of a kidnap, the insurance contracts provide unlimited (free) access to a crisis response company.⁴⁴ Experienced crisis response consultants usually arrive within 24 hours of the kidnap to advise stakeholders. They convey information about the kidnapping gang's previous conduct (including advice on whether to involve the local police) and to inform stakeholders of the target settlement price and expected ransom duration. They reassure stakeholders during threats and advise them on their negotiation strategy (Hiscox 2014, p19, Financial Times 2011). Moral suasion is used to avoid early premium settlements by cash-rich victim stakeholders, alerting them to their responsibilities vis-à-vis future victims

⁴² This was confirmed by studying sample contracts and promotional material on the websites of various kidnap for ransom insurers.

⁴³ "*K&R policies include a requirement that they are kept confidential.*" Marsh 2011 p5

⁴⁴ See table 1 for the crisis responders used by each insurer. Also see Marsh 2011

and the risk of a “revised” demand if too much is offered too quickly (Interviews V, X, XI, March 1988). Consultants remain assigned to the case until it is resolved or the victim is proven dead (Interview IV, Hiscox 2014, p19).

Although the consultants are ultimately paid by the insurer, this is an arm’s length relationship: the consultants are not instructed how to handle individual cases or when to terminate them. Instead, crisis consultants operate in a highly competitive environment, with different consultancies seeking to be the “named” responder on particular policies (Interview V). Only the biggest kidnap insurers retain full time consultants, the rest are employed on a case-by-case basis (Interview IV, V, VI).⁴⁵ Consultants build reputations for good settlements and expertise in particular areas. Knowledge of “botched” negotiations quickly spread in the community of insurers and response companies.

Taken together, the Lloyd’s system looks very much like Coase’s alternative solution to the externalities problem with high transaction costs: a government, which “...*may impose regulations which state what people must or must not do and which have to be obeyed... decree that certain methods of production should or should not be used...*” (Coase 1960 p17). However, in this case the threat is not “else you will go to jail” or a large fine: the ultimate sanction is to lose the benefits of club membership (Stringham 2015).

5. Voracious Internalising

⁴⁵ Tokio Marine is an exception, its “in-house” kidnap division appears to be a loss-leader (Interview XII).

Firms and families who are not properly advised may well pay outlier ransoms. As insurers do not reveal themselves in insured cases, any premium ransom has the potential of raising kidnapper expectations. There is therefore a strong incentive to internalize externalities from uninsured cases as well.

5.1. Preventing spill-overs from self-insurance

For many companies paying even a significant one-off ransom is not problematic. One interviewee quoted a customer in the oil sector faced with a million dollar ransom demand: *“Why don’t we just give them a million dollars? We spill more than that in a day...”* (Interview IV). Yet, according to The Guardian (2014) *“... at least 75% of Fortune 500 companies hold K&R insurance policies...”* Why do these companies insure kidnap risks?

Mayers and Smith (1982) argue that insurers have a comparative advantage in providing services related to claims management and in monitoring compliance with risk mitigation guidelines. Indeed, kidnap insurers foreground the specialist services of crisis response companies in risk mitigation, negotiating and delivering ransoms. They also insure employers for legal liability arising from kidnap cases (Business Insurance Online 2012). Corporations fear litigation unless they have demonstrably followed “best practice”. Kidnap specialists use part of the insurance premium to provide training and security advice for the companies’ staff and security checks of the premises of their overseas operations (Business Insurance 2008). Thereby, companies cannot be accused of not trying to prevent abductions in the first place. If a kidnap occurs, the insurer’s experienced crisis consultants reduce the likelihood of a bad outcome (Merkling and Davis 2001) and the probability of an employer being found negligent. Kidnap insurance is therefore attractive even to companies which

could theoretically self-insure. Major companies which do self-insure have direct contracts with the risk consultancies to prevent and resolve kidnap cases.⁴⁶

Voracious internalising is also likely to be behind the inclusion of kidnap cover in the “Gap Year Insurance” sold by Hiscox.⁴⁷ This prevents well-off families from self-negotiating and inadvertently changing kidnapper expectations. Because the insured party knows that insurance was purchased, a low ransom limit is used to reduce moral hazard. Effectively it is a “claims only” contract of the type described by Mayers and Smith (1982 p285), where the insurer provides the claims management services, but the insured pays the claim.

5.2. “pro bono services to promote market stability”

Sometimes uninsured people are taken hostage. If the incident can create spill-overs, it is in the interest of kidnap insurers to control these negotiations. Two illustrative cases are the snatching of Judith Tebbutt from a Kenyan beach resort and the hijack of the Chandler couple from their private yacht by Somali pirates. Had these kidnaps been profitable they might have broadened the targets of Somali pirates from commercial shipping. The families were therefore offered *pro bono* expert advice and coached in how to conduct the negotiation.⁴⁸

The cost of staging the Chandler kidnap and the extended negotiation period were considerable. World Bank (2013) estimated the start-up cost of a piracy team at just below US\$80,000, on which investors would expect a financial return in the region of 430%. NYT

⁴⁶ E.g. the international oil giant case study on the Olive Group website.

http://www.olivegroup.com/cst_details.php?cstid=3

⁴⁷ <http://www.hiscox.co.uk/travel/gap-travel-insurance/details-of-cover/>

⁴⁸ House of Commons 2012 Ev 71

(2011) reports an estimated cost of US\$20,000 a month in food and guards' wages. The 388 day negotiation would have cost around \$250,000. A host of local power-brokers expected protection money (Shortland and Varese 2014). Yet, the House of Commons (2012) reports a final ransom of just US\$440,000, meaning that the Chandler kidnap resulted in a large number of disappointed investors, pirates, guards, local suppliers and protectors. The case of Judith Tebbutt appears to have been resolved on a similar basis (The Guardian 2012).

Although *pro bono* advice is presented as being given on humanitarian grounds, the approach in cases with clear scope for considerable externalities contrasts sharply with that of the "forgotten mariners" in Somalia. Here the victims are from poor countries, the ship-owners have abandoned them and their families have nothing substantial to offer. There is no business case for helping them and indeed commercial involvement in these cases is limited (The Telegraph 26 March 2015).

6. Conclusions

The market for kidnap insurance is characterized by externalities: cash-rich victim stakeholders can increase kidnappers' ransom expectations and encourage new kidnappings. Insurers need to prevent quick payments of premium ransoms, but can only do so at a cost. The private short-term benefits from containing ransoms are less than the benefits to the sector as a whole – myopic stakeholders are tempted to cut corners. For the market to be stable and risks to be calculable, this externality needs to be managed. Given the impossibility of enforcing "proper" ransom negotiations through contracts due to high transaction costs,

Coase would predict a single supplier of kidnap insurance. On the other hand, customers expect choice and competition when buying insurance.

The Lloyd's solution is therefore an ingenious answer to the problems presented by kidnap insurance. By setting clear parameters for commercial resolution Lloyd's enables "fair" competition between different providers and avoids kidnap insurance being sold monopolistically. There is a protocol for insuring and resolving kidnaps. Its use is mandatory and it (largely) prevents individual insurers from conferring externalities to the rest of the sector. The insurance market works smoothly because Lloyd's enables relevant case information to flow easily between insurers without compromising client confidentiality. Underwriters' desks are staffed by a few individuals who constantly interact with each other. Individual underwriters would be ostracized if they did not pass (truthful) information to the Lloyd's insurance community or spread it beyond its confines.

Kidnap insurance is therefore a perfect example of the way in which externalities and transactions costs shape the institutions which make up the economic system (Coase 2012 p13, Williamson 2002). The analysis also contributes to the literature which points out the elegance and ingenuity of (informal) private solutions to seemingly intractable governance problems (Munger 2010). As a "single firm" Lloyd's internalizes externalities, but it also preserves a reasonably competitive market for kidnap insurance by imposing certain rules on its members. Because Lloyd's is in essence a private members club, its threat of closing down "rogue" syndicates is credible – there is no legal redress if a syndicate is closed (Stringham 2015). This allows Lloyd's to act like a government vis-à-vis its members, regulating the methods of production. This perfectly satisfies the "transaction cost economics" school of thought (Williamson 2002): Lloyd's minimizes transaction costs by setting and enforcing

desirable rules for the market to function without recourse to costly legal appeals. Lloyd's role as a "private regime" in international private governance therefore has a clear basis in Cosean economics (Cutler et al 1999b).

There is an important policy implication of this analysis. Governments which intervene on behalf of kidnapped citizens regularly pay premium ransoms (NYT 2014). Unlike the participants in the private governance regime of kidnap for ransom, governments often act myopically and under media pressure. They have neither binding budget constraints nor a profit motive to contain ransoms. There is no mechanism to internalize the spill-overs of government settlements on other negotiations. Paying multi-million dollar ransoms solves political problems in the short term but confers significant externalities on current and future kidnap victims, their governments and the insurance sector. Ransom inflation in the private sector has been contained by increased patience on the side of private negotiators, spending additional weeks and months convincing kidnappers that private ransoms will not be comparable to government-funded ransoms. However, given the inexorable rise of ransoms in the government-negotiated sector and their worrying implications for terrorist financing, one should consider whether employing private sector solutions would not achieve the same end ("*the timely and safe return of the hostages.*"⁴⁹) more reliably and at a fraction of the price.

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⁴⁹ Hiscox 2014 p23

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Figure 1: Pirate ransoms in Somalia by attack date (De Groot et al 2011)

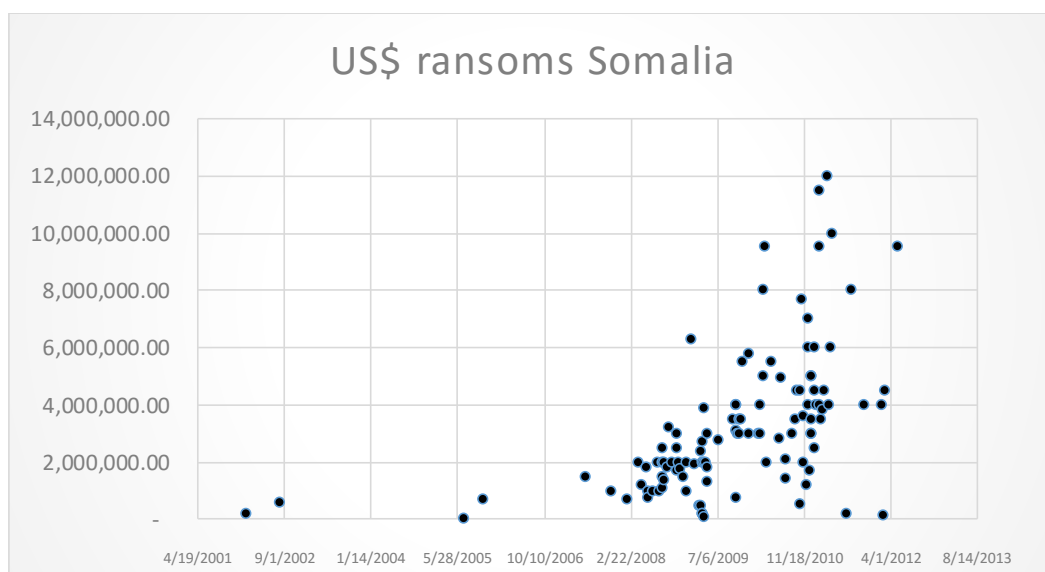


Figure 2: Ransoms paid in Nigeria 2006-2014 (Control Risks database)

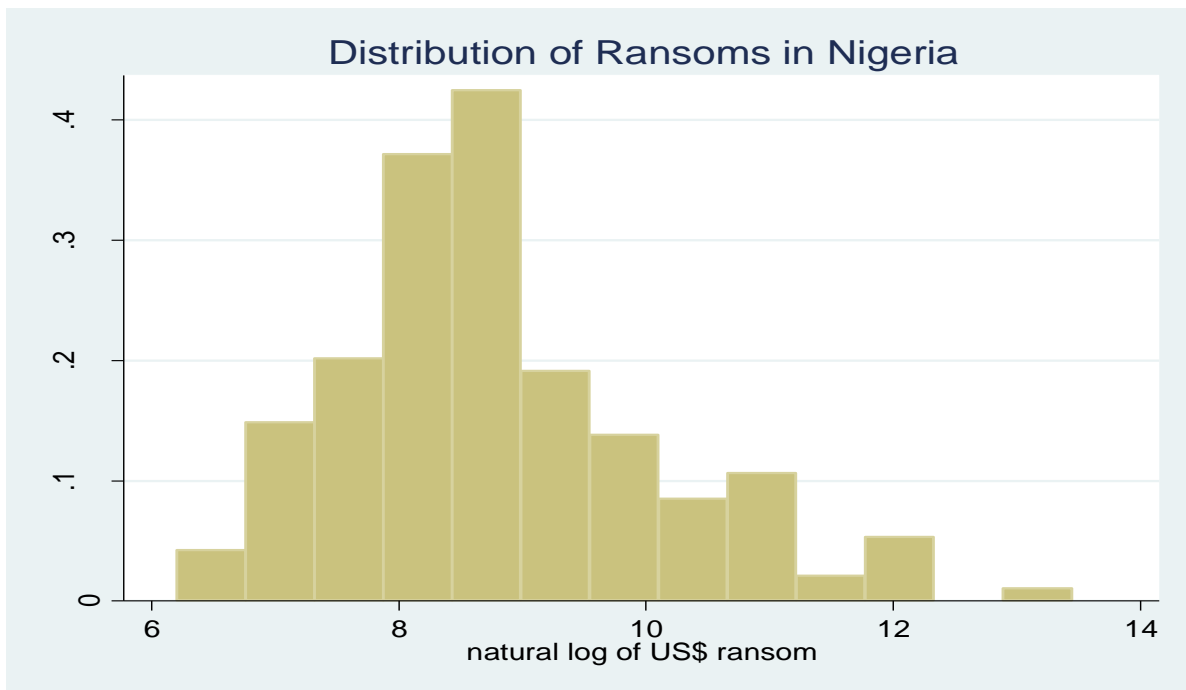


Figure 3: Ground floor underwriters' room at Lloyd's (Lloyd's 2015)



Table 1: Insurers, Underwriters and Crisis Responders

Insurers	Underwriters	Crisis Responder(s)
ACE	Lloyd's Syndicate 2488	Red 24
AIG	American International Group	Neil Young Associates
ANV	Lloyd's Syndicates 779, 1861, 1969 & 5820	MS Risk
AON (AON Benfield)	Specialist insurer founded by Lloyd's brokers	Neil Young Associates
Ascot	Lloyd's Syndicate 1414	MS Risk
Aspen	Lloyd's Syndicate 4711	AKE, Aegis Response, Henderson Risk
Beazley Furlonge	Lloyd's Syndicates 623, 2623, 3623, 362 & 6107	MAST
Canopus	Lloyd's Syndicates 958 and 4444	"Supported by expert crisis consultants" ⁵⁰
Chubb	Lloyd's Syndicate 1882	Ackermann
CV Starr	Lloyd's Syndicate 1919	Neil Young Associates
DUAL	Owned by Hyperion, a specialist insurer founded by Lloyd's brokers and merged with several further Lloyd's brokers.	MS Risk
Griffin	Specialist insurer founded by Lloyd's brokers	Security Exchange
Hiscox	Lloyd's Syndicate 33	Control Risks
Houston Casualty	Lloyd's Syndicate 4141	Unity Resources
Ironshore	Lloyd's Syndicates 4000 and 2014	Hazelwood
Liberty	Lloyd's Syndicate 4472	Unity Resources
Tokio Marine Kiln	Lloyd's Syndicates 510, 557, 1880	"In house" response team
Travelers	Lloyd's Syndicate 5000	Olive
QBE	Lloyd's Syndicates 386 and 2999	Red 24
XL Catlin (merged in 2015)	Lloyd's Syndicate 2003	Terra Firma, Red 24, Compass Risk Management

⁵⁰ <http://www.canopus.com/what-we-do/political-risk-crisis-management/crisis-management/kidnap--ransom/>

Appendix A: Interviews

Interview I: Professional Ransom Negotiator interviewed in March 2012

Interview II: Professional Ransom Negotiator interviewed in March 2012

Interview III: Professional Ransom Negotiator interviewed in December 2014

Interview IV: Professional Ransom Negotiator interviewed in January, February, May and June 2015

Interview V: Professional Ransom Negotiator interviewed in March and May 2015

Interview VI: Professional Ransom Negotiator interviewed in April 2015

Interview VII: Attorney interviewed in March 2012

Interview VIII: Attorney interviewed in April 2013

Interview IX: FCO official interviewed in January 2015

Interview X: Per Gullestrup, Former CEO, Clipper Shipping Group interviewed in January 2015

Interview XI: Ship owner and piracy victim interviewed in February 2015

Interview XII: Employee Crisis Response Company Interviewed February and March 2015

Interview XIII: Employee Crisis Response Company Interviewed January 2015

Interview XIV: Partner Crisis Response Company interviewed April 2013

Interview XV: Family member of kidnap victim interviewed June 2013

Interview XVI: Interview with insurance specialist. June 2015