

Reputational Risk as an Actuarial Professional

Subset of slides (without Case Study)



Speakers: Todd Hess & Melissa Huenefeldt
Moderator: Josh Merck



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Agenda

- Case study on Complex Structured Financial Transactions (CSFT)
- Relationship of CSFT rules to Code of Professional Conduct
- Discussion questions & Kahoot





Complex Structured Financial Transactions (CSFT) Regulatory rules to be aware of when structuring transactions



When structuring/selling/reviewing CSFT every party should be aware that such transactions might pose heightened levels of legal or reputational risk to the relevant institution due to:

- Lack economic substance or business purpose;
- Are designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year end or at the end of a reporting period for the customer;
- Raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or with applicable regulatory or accounting requirements;
- Involve circular transfers of risk (either between the financial institution and the customer or between the customer and other related parties) that lack economic substance or business purpose;
- Involve oral or undocumented agreements that, when taken into account, would have a material impact on the regulatory, tax, or accounting treatment of the related transaction, or the client's disclosure obligations;
- Have material economic terms that are inconsistent with market norms (*e.g.*, deep "in the money" options or historic rate rollovers); or
- Provide the financial institution with compensation that appears substantially disproportionate to the services provided or investment made by the financial institution or to the credit, market, or operational risk assumed by the institution.



Heightened legal or reputation risk may exist due to:



A lack of economic substance or business purpose.



Questionable accounting, regulatory, tax objectives



Concerns that Client reporting may be inconsistent with substance of the transaction or accounting /regulatory requirements



Circular transfers of risk affecting appearance but not substance



Inappropriate or inadequately disclosed side agreements



Material economic terms inconsistent with market norms



Substantially disproportionate compensation relative to services provided or risk transferred

Relationship of CSFT rules to Code of Professional Conduct



Transaction flaws that can damage reputations & potential consequences

1. Lack of economic substance or business purpose.

Precept 1: Professional Integrity

“An Actuary shall act honestly, with integrity and competence, and in a manner to fulfill the profession’s responsibility to the public and to uphold the reputation of the actuarial profession.”

Example: “Sham reinsurance” deal from 2006: no risk transfer due to secret side agreement

- Fines well in excess of the economic upside
- Criminal exposure



Transaction flaws that can damage reputations & potential consequences

2. Questionable accounting, regulatory, and tax objectives

Precept 1: Professional Integrity
(Annotation 1-2)

“An Actuary shall not provide Actuarial Services for any Principal if the Actuary has reason to believe that such services may be used to violate or evade the Law...”

ASOP 7: Analysis of (L&H, P&C) Insurer Cash Flows
(3.8 Reinsurance)

“The Actuary should consider whether reinsurance receivables...may be reasonably expected to have a material impact on the cash flow analysis.”

Example: “Sham transaction” shifting profit from one year to the next

- Tighter regulatory scrutiny that can limit future opportunity
- Civil and criminal exposure, potential bar from SEC-regulated position



Transaction flaws that can damage reputations & potential consequences

3. Client reporting transaction in a way that is inconsistent with the substance of the transaction or accounting regulatory requirements.

Precept 8: Control of Work Product

“An Actuary who performs Actuarial Services shall take reasonable steps to ensure that such services are not used to mislead other parties.”

Example: False financial statement taking credit for unfunded reinsurance

- Regulatory scrutiny
- Receivership
- Civil and criminal exposure



Transaction flaws that can damage reputations & potential consequences

4. Circular transfers of risk that affect the appearance but not the substance of the underlying risk.

Precept 1: Professional Integrity
(Annotation 1-4)

“An Actuary shall not engage in any professional conduct involving dishonesty, fraud, deceit, or misrepresentation...”

Example: Investment into a principle when the original money came from the counterparty

- Fines well in excess of the economic upside
- Criminal exposure



Quiz time!



- On your phone or tablet, go to kahoot.it
- Enter the game pin
- Enter your nickname (get creative!)

Kahoot!

Appendix





Transaction flaws that can damage reputations & potential consequences

5. Inappropriate or inadequately disclosed side agreements

Precept 1: Professional Integrity
(Annotation 1-4)

"An Actuary shall not engage in any professional conduct involving dishonesty, fraud, deceit, or misrepresentation..."

Precept 8: Control of Work Product

"An Actuary who performs Actuarial Services shall take reasonable steps to ensure that such services are not used to mislead other parties."

Example: Many until new regulation in 2005

- New regulation (NYDOI disclosures)
- Unwinding agreements
- Criminal exposure
- Financial pain for shareholders, policyholders, and taxpayers



New York Insurance Department Circular on Finite Reinsurance: March 2005



Chief Executive Officer to attest, under penalty of perjury, that with respect to cessions under any reinsurance contract, that:

- I. there are no separate written or oral agreements that would under any circumstances, reduce, limit, mitigate or otherwise affect any actual or potential loss to the parties under the reinsurance contract; and
- II. for each such reinsurance contract, the reporting entity has an underwriting file documenting the economic intent of the transaction and the risk transfer analysis evidencing the proper accounting treatment, which is available for review.

In addition, the Department will require increased disclosure of finite risk transactions in the annual statement, including the attestation described above."



Transaction flaws that can damage reputations & potential consequences

6. Material economic terms inconsistent with market norms

ASOP 41: Actuarial Communications

(3.4.4 Responsibility for Assumptions and Methods)

“An actuarial communication should identify the party responsible for each material assumption and method.”

Example: Scheme where MGA set reinsurance price for cover placed with reinsurer owned by the owner of the MGA

- Loss of public trust
- Erosion of client base
- Fines



Transaction flaws that can damage reputations & potential consequences

7. Substantially disproportionate compensation relative to services or risk transferred

Precept 1: Professional Integrity

"An Actuary shall act honestly, with integrity and competence..."

Precept 3: Standards of Practice

"An Actuary shall ensure that the Actuarial Services performed by or under the direction of the Actuary satisfy applicable standards of practice."

Example: Credit default swaps preceding housing market crash

- Loss of public trust
- Erosion of client base
- Threatened survival

