

# FINITE REINSURANCE ISSUES CASUALTY ACTUARIAL SOCIETY

## SEMINAR ON RATEMAKING

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# Issues:

- What is finite reinsurance?
- The current legal landscape surrounding finite reinsurance:
  - Regulatory investigations
  - Suits by creditors/investors/receivers
  - Trend toward expanded responsibility and exposure
    - Homestore.com
    - Joint Agency Statement
    - NAIC Task Force
- Red Flags
- Recommendations



# What is it?

- Regulators and the media have used the term “finite” reinsurance as shorthand for sham reinsurance. This is simply not accurate.
- Label used to describe a wide variety of arrangements where the amount of insurance risk transferred is subject to specified limits



# What is it? (con't.)

- A finite reinsurance agreement is not a distinct form of reinsurance; any type of reinsurance can be written using a finite reinsurance agreement.

Principles of Reinsurance, Elliott, Webb, Anderson, Kensicki p. 164

- Finite reinsurance differs from “traditional” reinsurance agreements because there is a smaller chance that losses will exceed premium, and, even if they do, the amount the reinsurer could lose is carefully controlled.
- In traditional reinsurance, uncertainty as to amount of loss is the primary driver. In finite reinsurance, timing is often the primary driver.



# What is it? (con't.)

**No single definition or arrangement - think of a continuum:**

- on one end, a traditional policy with a retention or retro premium
- on the other end, true financial insurance where interest rate and timing risk transferred but no underwriting risk
- “finite” reinsurance falls between these two extremes



## Premise of transactions:

- insured/reinsured will pay for most of its losses (through premiums and recognition of investment income) but will also share in profits on book if loss experience is favorable
- enough insurance risk transferred to be treated as insurance/reinsurance for accounting purposes (GAAP and SAP)



## **Can take many different forms and are used for many different purposes:**

- loss portfolio transfers
- aggregate stop loss covers
- finite quota share
- multi-year cat covers
- adverse loss development cover



## What is the advantage to characterizing a transaction as reinsurance? (con't.)

- Under SFAS 113 (GAAP), SSAP 62(SAP):
  - reinsurer must assume “significant insurance risk”
  - It must be “reasonably possible” that reinsurer might realize “significant loss” from transaction
- If a contract satisfies risk transfer test for reinsurance
  - premium ceded reduces written premium
  - amount recoverable from reinsurer reduces insured losses or is reportable as an asset



## What is the advantage to characterizing a transaction as reinsurance? (con't.)

- If contract does not transfer risk there is no change in written premium, earned premium or incurred losses
  - reinsurance premium is considered to be a deposit
  - recorded as asset on books of cedent
  - payments received from reinsurer are recorded as investment income and return of deposit



# Why Buy Finite Reinsurance?

- Because finite reinsurance limits the risk transferred to the reinsurer, it is less expensive or may be available when traditional reinsurance is not.
- To the extent it satisfies risk transfer requirements, it also satisfies other objectives of reinsurance *i.e.* reduces underwriting volatility, provide capacity to write larger limits or more business, reduces leverage.
- Move away from finite reinsurance may increase costs and reduce market availability



# Criticisms of Finite Reinsurance

- Finite reinsurance characterized as form over substance, used by buyers to inflate their financial position and operating results.
- Finite reinsurance can be used to increase current period earnings and period end surplus by moving into a future period a loss that would have been reported in the current period.



# Finite Reinsurance Governed by GAAP and SAP Accounting and Reporting Requirements

- Although finite reinsurance contracts may provide for less risk transfer than traditional reinsurance, they still must meet GAAP and SAP guidelines for reinsurance accounting.
- SFAS 113 and SSAP 62 intentionally adopt principle-based rather than rule-based guidance
  - “Because the Board concluded that the cost of implementing very detailed standards for reinsurance accounting would outweigh the benefits, the overall approach of providing general rather than detailed guidance was retained.” SFAS 113 para. 43
- SFAS 113 and SSAP 62 require the exercise of professional judgment to determine risk transfer.
- Reinsurance which, as a matter of professional judgment, includes the appropriate level of risk transfer should not be characterized as being used solely to improve financial results.
- All insurance and reinsurance contracts are designed to smooth earnings.



# Current Legal Landscape

- Regulatory Investigations
- Subpoenas from SEC, AG and insurance regulators re finite reinsurance
  - AIG
  - Berkshire Hathaway (General Reinsurance)
  - Platinum Underwriters Holdings Ltd.
  - ACE Ltd.
  - Chubb
  - Swiss Reinsurance Co.
  - St. Paul Travelers
  - Zurich Financial Services
  - Munich Re
  - Renaissance Re Holdings, Ltd.



# Legal Landscape

- Accounting treatment can be challenging because it involves analyzing complex contracts where the range of possible outcomes is uncertain.
- Appropriate accounting and reporting treatment require the exercise of professional judgment to determine whether present value of all cash flows under reasonably possible outcomes results in a reasonable possibility of a significant loss to the reinsurer.
- Remember that we apply these standards at the outset of the transaction, but regulators and others have been looking at them with 20/20 hindsight, e.g. Platinum Underwriters announced in Nov. 2004 that it was canceling a finite reinsurance contract under which it was owed \$22 million, because of heightened concern over insurance accounting even though Platinum claimed the contract involved substantial risk transfer.
- Regulatory concern that these kinds of transactions are forms of earnings manipulation.



- Spitzer and SEC expansive definition of “nontraditional” product
  - Product that could be or was used to affect the timing or amount of revenue or expense recognized in any particular reporting period, including without limitation, transferring financial assets off of a balance sheet, extinguishing liabilities, avoiding charges or credits to financial statements, deferring the recognition of a known and quantifiable loss, or transferring risk through an insurance transaction in which a material term relating to such risk transfer (whether or not legally enforceable) is not reflected in the formal written contractual documentation for the transaction.



# Statutes

- All states required licensed companies to file annual financial statements prepared in accordance with the annual statement instructions and the NAIC Accounting Practices and Procedures Manual.
- Approximately nine states have adopted statutes specifically requiring that the commissioner disallow any asset or credit based on reinsurance found, after a hearing, to have been arranged for the purpose of enabling the ceding company to file deceptive financial statements.



# Litigation

## Brightpoint (SEC/DOJ)

- Sept. 2003, AIG pays \$10M to settle civil charges brought by SEC in connection with sale of retroactive loss mitigation policy to Brightpoint, a small mobile phone distributor.
- SEC charged AIG with fraud for allegedly helping Brightpoint overstate 1998 earnings by issuing a “bogus” insurance policy.
- Policy designed to reduce one-time charge relating to loss sustained in UK division. Brightpoint announced in October 1998 it would recognize \$13-18M one-time charge in the 4th quarter arising out of losses in its UK division, which it was closing. By December, losses had allegedly grown to \$29 million.



# Brightpoint

- AIG/Brightpoint constructed combined policy - Coverage A - covered virtually every loss of assets up to \$15M; Coverage B - prospective fidelity coverage
- Policy enabled Brightpoint to record insurance receivable of \$11.9M
- Cost of policy was \$15M to be paid over 3 year term
- Policy backdated by several months; covered virtually every loss of assets
- Alleged oral understanding to refund excess premiums (no experience account).
- SEC alleges that there was no transfer of risk



## Brightpoint (con't.)

- As outgrowth of Brightpoint, SEC probe found that AIG helped PNC create 3 special purpose entities to remove \$762M of under-performing loans and volatile VC investments off PNC balance sheet.
- Nov. 2004, AIG pays \$126M to settle complaints and investigations by SEC, DOJ (U.S. Attorney's Indianapolis office) involving allegations that AIG sold products which helped PNC and Brightpoint engineer their financial statements



## **HIH Insurance Group: Australia's largest corporate failure:**

- Placed into receivership on March 15, 2001
- Royal Commission Report:
  - HIH's use of reinsurance was "audacious"
  - No real transfer of risk
  - Side letters/contracts split into several components
  - Unrealistic triggers of cover
  - Backdating of documents
  - Purpose of transactions was to conceal under-reserving and overstate profits



## HIH Insurance Group (con't.)

Resulted in \$300 million returned to HIH liquidator from reinsurers under cancellation of between 10 to 15 reinsurance treaties:

- difficult to say what portion was an unwinding of the contracts and what portion was a commutation under commutation provisions of those contracts
- Liquidation proceedings may last for a decade



# Fortress Re

- Pool of Japanese reinsurers managed by Fortress Re.
- Involves allegations that financial reinsurance transferring no underwriting risk was used to disguise Pool's financial results.
- Arbitration panel awarded one Pool member (Sompo Japanese Insurance Co.) \$1.12 billion in arbitration against Fortress Re, finding actual and constructive fraud, violation of management agreement and breach of fiduciary duties.



## Fortress Re (con't.)

- Suits against Deloitte & Touche LLP allege that financial accounting approved by D & T enabled Fortress Re to conceal more than \$2.2 billion of estimated liabilities and that D & T should have required disclosure of the financial reinsurance.



## Reciprocal of America Litigation (“ROA”)

- Placed in receivership January 29, 2003. Order of Liquidation entered June 20, 2003.
- Five class actions, two actions by receivers and other federal lawsuit.
- Complaint alleges that demise of ROA was caused by a protracted conspiracy among company's management and third parties to conceal the company's financial difficulties.
- Claims against Gen Re and others.
- Allege reinsurers knew that ceding companies were not properly accounting for agreements - no “substantial” risk transfer.
- Allegations that reinsurers participated in conspiracy to hide ceding companies' financial condition
- Allegations of undisclosed side letters, retroactive amendments to reinsurance agreements to modify coverage limits
- Litigation is in early stages, but if plaintiff's position is that, while agreements transferred some risk, amount of risk transferred was not sufficient it opens the door to substantial second guessing.



# Brightpoint, HIH and Fortress Re

- Brightpoint, HIH and Fortress Re all involve allegations that transactions characterized as insurance/reinsurance transferred no risk
- Transactions involving no risk transfer result in potential exposure for both buyers and sellers
- If a transaction fails the risk transfer test there must be a legitimate business purpose for transaction and it must be characterized, labeled and reported as a deposit or loan



# The Trend Toward Expanded Responsibility and Exposure

- Simpson v. Homestore.com
- Joint Interagency Statement on  
Complex Structured Financial  
Activities



# Homestore.com, Inc., et al.

- Case involves allegations that Homestore.com, Inc., a leading internet provider of real estate listings and home purchasing and moving services, and several of its business partners engaged in a scheme to defraud investors by entering into deceptive transactions whose purpose and effect was to falsely inflate revenues.
- Defendants included three companies, AOL Time Warner, Cendant and L90, Inc., that were Homestore's partners in the transactions.



## Homestore.com, Inc., et al. (con't.)

- SEC position (Amicus Brief, October 2004): third party that engages in a transaction whose principal purpose and effect is to create a false appearance of corporate revenues can be liable as a primary violator rather than an aider and abettor under Rule 10b-5.
- Significance of SEC position: private actions can be brought only against primary violators and not against aiders and abettors.



# Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities

- OCC, OTS, Federal Reserve, FDIC, SEC
- Applies to: national and state banks, bank holding companies, federal and state savings associations, savings and loan holding companies, SEC registered broker dealers and investment advisors
- Many specific provisions are based on some of Enron's more notorious transactions



# Interagency Statement on Sound Practices (con't.)

- Outlines internal controls and risk management procedures designed to ensure that financial institutions comply with law and effectively manage the legal and reputational risks associated with these products
- Statement seems to impose on a financial institution a duty to police customer accounting, disclosure and tax practices
  - greatly increases potential liability and exposure
  - imposes new costs and burdens



# Where are we going?

- A few notorious no risk transfer examples
- Unfocused investigations
- Regulatory and judicial second guessing?
- Platinum Underwriters rescission,  
Renaissance Re restatement
- Proprietary modeling by rating agencies



# NAIC Accounting Practices & Procedures Task Force/P&C Reinsurance Study Group

- NAIC Accounting Practices and Procedures Task Force/Property & Casualty Reinsurance Study Group recommends regulatory disclosure and review
  - Ceding company must maintain required documentation (u/w and cash flow analysis) for regulatory review to avoid deposit accounting
  - Expanded disclosure obligation may require clearer regulatory/accounting guidance as to contracts requiring disclosure/review
  - What purpose is served by disclosure of reinsurance which meets risk transfer threshold?
  - What disclosure will be required?



# In the Meantime

## Red Flags:

- Near complete sharing of profit and loss
- Historical results indicate losses within reinsurance layer are not uncertain
- Side Agreements
- Multi year contracts where total premiums approach aggregate limit



## Recommendations:

- Establish a process for finite reinsurance transactions
- Know your business partner
- Document modeling process
- If transaction fails risk transfer test, it must be characterized as a deposit or loan
- Support assumptions
- Preserve documentation
- Involve auditors
- Disclose to transaction partners
- Reflect the entire transaction in the contract

