Swiss Re

Reputation Risk in Transactions

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Context

In the face of a soft reinsurance market, competition vs other forms of capital, and insurance company growth pressures, the risk of insurers and reinsurers pressing the boundaries of reinsurance accounting and other reputational risks is high.

"It takes many good deeds to build a good reputation and only one bad deed to lose it."

- Benjamin Franklin

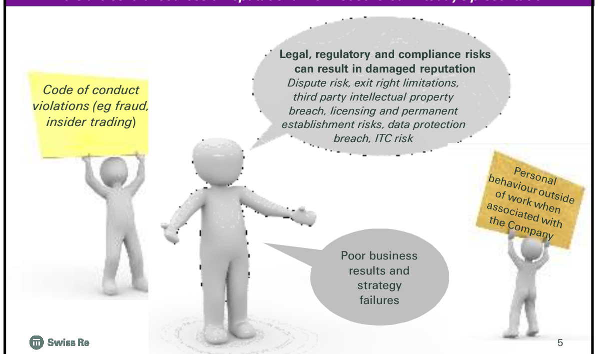
Today's focus

Reputation risks from:

- Originating,
- Underwriting
- *and*
- Structuring transactions

Focus on reputational risk arising from originating, underwriting and structuring of transactions

There are several sources of reputational risk not covered in today's presentation



Pressure to excel can result in mistakes and lead to vulnerability (or worse)

- Taking shortcuts to solve the problem or cheating to solve the impossible
- Culture that discourages problem acknowledgement
- Pressure for growth/earnings
- Excessive leverage because chance of loss perceived to be small
- Desire to please
- Greed

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Principles and Examples

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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.

OCC BULLETIN 2007-1
http://www.occ.gov/news-issuances/bulletins/2007/bulletin-2007-1.html

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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

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Transaction flows that can damage reputations

Potential consequences

1. Lack of economic substance or business purpose

Example: "Sham Reinsurance" deal from 2006: no risk transfer due to secret side agreement

Fines well in excess of the economic upside

Criminal exposure

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Transaction flaws that can damage reputations

Potential consequences

2. Questionable accounting, regulatory, and tax objectives

Example: "Sham Transaction" shifting profits from one year to the next

Tighter regulatory scrutiny that can limit future Opportunity

Civil and criminal exposure, potential bar from SEC regulated postiotn.

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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 or regulatory requirements

Example: false financial statement taking credit for unfunded reinsurance

Regulatory scrutiny

Receivership

Civil and criminal exposure

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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

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

Fines well in excess of the economic upside

Criminal exposure

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Transaction flaws that can damage reputations

Potential consequences

5. Inappropriate or inadequately disclosed side agreements

Example: Many until new regulation in 2005

New regulation (NYDOI disclosures)

Unwinding agreements

Criminal exposure

Financial pain for shareholders, policyholders, and taxpayers

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NY Ins Dept 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."

http://www.dfs.ny.gov/insurance/circltr/2005/cl2005_08.pdf

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Transaction flaws that can damage reputations

Potential consequences

6. Material economic terms inconsistent with market norms

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

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Transaction flaws that can damage reputations

Potential consequences

7. Substantially disproportionate compensation relative to services or risk transferred

Example: Credit default swaps right before housing market crash;

Loss of public trust

Erosion of client base

Threatens Survival

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More detailed examples

Case review: Company X and Client Y

- Company X had a 6% share price drop, caused in part by reserve decrease
- Solution: Company X reinsured Client Y with $600m cover for $500m premium
- Company X reported increase in reserves and premium. It worked! Analysts noted:

"We think this quarter was a good example of Company X doing what it does best: growing fast and making the numbers"...

"As important was the change in reserves: Company X added $106 million to reserves ..."

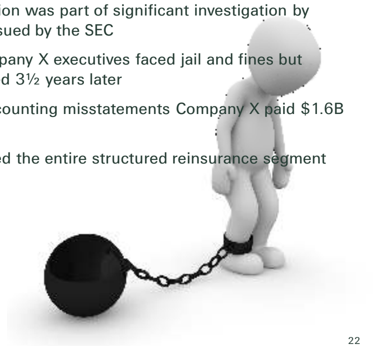
"Finally Company X put to rest a minor controversy from last quarter by adding $106 million to reserves ..."

Case review: Company X and Client Y

- Agreed in advance to unwind reinsurance with Company X paying Client Y $5m
  - Client Y booked as a deposit, Company X as reinsurance
- Relevant elements of CSFT guidance
  - Circular transfers of risk that affect the appearance but not the substance of the underlying risk
  - Questionable accounting, regulatory, and tax objectives
  - May be reported by client in a way that is inconsistent with the substance of the transaction or accounting or regulatory requirements
  - Inappropriate or inadequately disclosed side agreements
  - *Material economic terms inconsistent with market norms*
  - *Substantially disproportionate compensation relative to services provided or risk transferred*

Case review: Company X and Client Y

- Discovery of transaction was part of significant investigation by Elliot Spitzer and pursued by the SEC
- 4 Client Y and 1 Company X executives faced jail and fines but convictions overturned 3½ years later
- For this and other accounting misstatements Company X paid $1.6B to settle civil charges
- This example damaged the entire structured reinsurance segment for years to come.



Ceding Insurance Company (CIC)

(Anonymized and exaggerated real case)

Gross Premium Income	200m
Surplus requirement as % Net Premium, maximum ceded reinsurance 50%	40%
Required Surplus without Reinsurance	80m
Current Surplus	40m

- **Client goals**
  - No additional surplus injection
  - Minimal cost, retain underlying profitability
  - Risk transfer for reinsurance accounting

Ceding insurance company (CIC)

Challenges

- Profitability is thin per CIC's estimate and essentially zero in Reinsurer's view
- CIC expected gross margin: 5m out of 200m premium
- Reinsurer's view of expected gross margin: negative 200K
- Buyer happy to retain extra risk as trade-off for keeping more of the upside

It's an important new business opportunity!!!

Ceding insurance company (CIC)

Solution: 50% Quota Share

Sliding Scale Commission
- Min 5%
- Max 45%
- Formula: Premium – loss – 5% Reinsurance Margin

Note: Company expenses = 25%

Net Premium = 50% of 200m = 100m

Required Surplus = 40m

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CIC Reinsurance Results: Reinsurer perspective

Probability	Loss Ratio	Ceded Loss	Cmsn	Ceded Profit or (loss)	Risk Transfer?
10%	45%	45	45	10.0	
10%	50%	50	45	5.0	
28%	62.5%	62.5	32.5	5.0	
22%	75%	75	20	5.0	
11%	85%	85	10	5.0	
7%	95%	95	5	0.0	
7%	105%	105	5	(10.0)	x
5%	115%	115	5	(20.0)	x
100%	73%			2.9	

Client needs met!
- Required Surplus of 40m
- Big commissions for Loss ratios below 75%
- Risk transfer because > 10 % chance of 10% loss to Reinsurer

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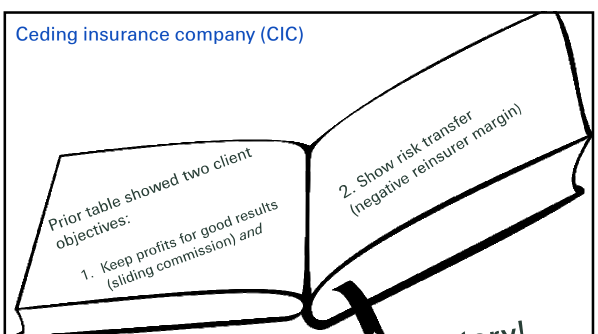
Ceding insurance company (CIC)



But there's more to the story!

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CIC **Net** Results: CIC perspective

Probability	Loss Ratio	Net Loss	Gross Expenses	Net Expenses (Gross less Cmsn)	Net Profit or (loss)	Ending Surplus
10%	45%	45	50	5	50.0	90
14%	50%	50	50	5	45.0	85
18%	63%	62.5	50	17.5	20.0	60
28%	75%	75	50	30	(5.0)	35
12%	85%	85	50	40	(25.0)	15
8%	95%	95	50	45	(40.0)	0
7%	105%	105	50	45	(50.0)	(10)
3%	115%	115	50	45	(60.0)	(20)
100%	72.4%				2.0	

Result: QS did not protect CIC's surplus

QS allowed CIC to function at half the Surplus needed w/o reinsurance but didn't help until CIC's surplus was wiped out!

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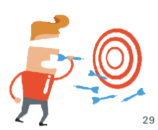
Review of elements of CSFT Guidance

1. Lack of economic substance or business purpose: CIC okay.
2. Questionable accounting, regulatory, and tax objectives: Goals reasonable.
3. May be reported by client in a way that is inconsistent with the substance of the transaction or accounting or regulatory requirements
   Will client accrue commission swings? Does regulator understand that the swing mechanism leaves substantial risk with cedent?
4. Circular transfers of risk that affect the appearance but not the substance of the underlying risk:
   Flag: Reinsurers pay losses but fund from lower commission.
5. Inappropriate or inadequately disclosed side agreements: None
6. Material economic terms inconsistent with market norms: Seems okay.
7. Substantially disproportionate compensation relative to services provided or risk transferred:
   Low margin, low risk. Common for some LOBs such as non-standard auto.

Message:
Consider client financials, not just their wish list!



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Potential reputation risk consequences

- May go undetected if results are good, but what if results are suboptimal?
- Increased scrutiny of regulators.
- Negative press
- Potential civil action from CIC shareholders
- One poor outcome can invite scrutiny of entire book
  - US: SEC investigated many reinsurers around 2006. Found little, but ...
    - Massive inconvenience
    - Cast shadow over reinsurance creativity and innovation
  - There have been states that disallowed commission swings

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Catastrophe insurance pool (CIP)

Client situation and background

CIP offers compulsory EQ insurance. There in an Undersecretary of the Treasurer who supervises and audits the activities of the pool. CIP is authorized to purchase reinsurance but needs the approval of the Undersecretary for any loans.

Client goals:

- Protect their net retention of 650m, particularly second event coverage
- Minimal cost, budget for reinsurance spend is 1%-2%

The broker presented the following solution to the reinsurance market.

Catastrophe insurance pool

Proposed treaty structure

Type:	EQ Catastrophe Excess of Loss Reinsurance Agreement
Period:	12 months
Layer:	250m excess 400m per occurrence
Premium:	3m
Additional Prem:	105.25% of ceded claims paid, subject to a maximum TBA
AP payment schedule:	4 payments at 6, 18, 30, and 42 months at 25%, 50%,75%, and 100% of the then calculated full AP.
Commutation:	Final settlement at 48 months from inception.

Catastrophe insurance pool

Client's needs are met

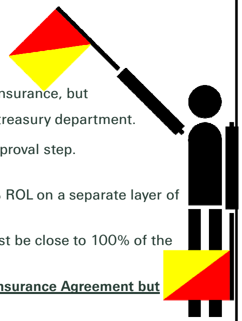
The structure addresses the concerns of the client

Client goals

- Protect their net retention of 650m, particularly second event coverage.
- Minimal cost, budget for reinsurance spend is 1%/2%

But flags abound . . . . . .

Catastrophe insurance pool
Potential reputation risk flags



- Background check of the transaction revealed
  - that the Pool has the authority to purchase reinsurance, but
  - would need approval for a loan from the state treasury department.

  Warning: The client hoped to avoid this approval step.

- The fee charged is very low => compares to a 5% ROL on a separate layer of the same tower.
- At the tiny charge, the cap of the Risk Charge must be close to 100% of the claims amount, i.e. no risk transfer.

The type of the arrangement was presented as Reinsurance Agreement but the structure has a clear loan characteristics.

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Review of elements of CSFT guidance CIP

1. Lack of economic substance or business purpose: CIP wanted treatment as reinsurance without paying for risk transfer
2. Questionable accounting, regulatory, and tax objectives: Flag that client wanted to avoid a regulatory approval
3. May be reported by client in a way that is inconsistent with the substance of the transaction or accounting or regulatory requirements
   Looked more like a loan than reinsurance.
4. circular transfers of risk that affect the appearance but not the substance of the underlying risk: CIP okay
5. Inappropriate or inadequately disclosed side agreements: CIP okay
6. Material economic terms inconsistent with market norms: Followed market terms for a loan, not reinsurance
7. Substantially disproportionate compensation relative to services provided or risk transferred: Compensation was too low for apparent risk

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Is there another path?

Some of these create difficult discussions:

- Within reinsurers
- With clients
- With regulators

A sample of questions a reinsurance deal lead may raise are shown on the next two slides

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I hear you, but ... (1 of 2)

"Our competitors are offering this solution."

"The client's CFO has signed off on this and if we don't write it we're accusing the client of bad behaviour. That will severely damage the relationship."

"The portfolio is very stable. It is extremely unlikely there will ever be a loss."

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I hear you, but ... (2 of 2)

"All the information has been provided to the regulator. They just need to connect the dots themselves."

"This portfolio is a relatively small part of the client's business."

"The client's owners will step in and support with more capital if needed"

"Our plan relies on doing Large Deals and this is one of few opportunities we have."

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Appendix

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Risk Transfer

- Reasonable possibility of significant loss
  . . . to the reinsurer
- Insurance Risk
  - Underwriting Risk (we don't know result ahead of time)
  - Timing Risk (timely reimbursement of losses)
- Substance issues (10/10, ERD--Expected Reinsurer Deficit)
- Form issues (no payment schedules or floating retentions, loss settlements at least quarterly, in some jurisdictions caps are disallowed)
- Curiously, no test that risk is actually transferred.

References (1 of 4)

The principle source for this talk is from the US Dept of Treasury Office of the Comptroller of the Currency.
http://www.occ.gov/news-issuances/bulletins/2007/bulletin-2007-1.html

The guidance following the list of 7 characteristics reads:

"The statement points out that if a financial institution determines through its due diligence that participation in a particular CSFT would create significant legal or reputational risks for the institution, the institution should take appropriate steps to address those risks. Such actions **may include declining to participate in the transaction, or conditioning its participation upon the receipt of representations or assurances from the customer that reasonably address the heightened legal or reputational risks presented by the transaction**. The statement also establishes that a financial institution **should decline to participate in an elevated risk CSFT if**, after conducting appropriate due diligence and taking appropriate steps to address the risks from the transaction, the institution determines that **the transaction presents unacceptable risk to the institution or would result in a violation of applicable laws, regulations, or accounting principles.**"

NY Ins Dept Circular on Finite Reinsurance. March 2005
http://www.dfs.ny.gov/insurance/circltr/2005/cl2005_08.pdf

References (2 of 4)

- "Road to Ruin – How insurance companies fail" by Professor Alan Punter, The Insurance Institute of Luton and St Albans, 29 Sept 2015
  http://www.localinstitutes.cii.co.uk/media/2888/luton-cii-talk-29-09-2015.pdf
- Presentation at CAS Spring Mtg May 6, 2009 by Dan R. Young, Esq., Attorney at Law: Actuarial Accounting: A Cautionary Report
  https://www.casact.org/education/spring/2009/handouts/young.pdf
- From caranddriver.com: "General Motors and Toyota had their massive scandals. Now it's Volkswagen's turn. The company, which owns 70 percent of the U.S. passenger-car diesel market, is in major trouble for cheating on diesel-emissions tests. After years of promoting "Clean Diesel" as an alternative to hybrid and electric vehicles—the company even marched on Washington with a squadron of Audi TDI models—Volkswagen is stewing in its own toxic vapors."

References (3 of 4)

- VW lingering headline headaches
  - Fraud charge as reported in May 3, 2018 NYTs. https://www.nytimes.com/2018/05/03/business/volkswagen-ceo-diesel-fraud.html?emc=edit_na_20180503&nl=breaking-news&nlid=47847018ing-news&ref=headline
  - NYTimes.com headline from 28 June 2016 "$14.8B fine just the beginning for Volkswagon"
  - VW took over top WW sales of cars in 2016 despite scandal due largely to China where they sell few diesel cars (The Guardian, https://www.theguardian.com/business/2017/jan/30/vw-diesel-emissions-scandal-volkswagen-audi-porsche-skoda-Toyota)
  - From http://ewn.co.za/2017/03/21/vw-emissions-scandal-could-spread-to-south-africa "**VW emissions scandal could spread to South Africa** Lawyer Damon Parker says the lawsuit is about ethics with people feeling cheated."
- https://en.wikipedia.org/wiki/HIH_Insurance
- https://en.wikipedia.org/wiki/The_Equitable_Life_Assurance_Society
- https://www.economist.com/finance-and-economics/2017/09/07/a-year-on-wells-fargo-cannot-shake-off-its-mis-selling-scandal

References (4 of 4)

- Comment on side letter quoted from http://ritholtz.com/2009/04/aig-before-cds-there-was-reinsurance/
  "In the regulatory world, a 'side letter' is perhaps the most insidious and destructive weapon in the white-collar criminal's arsenal. With the flick of a pen, underhanded executives can cook the books in enormous amounts and render a regulator helpless."
  Fraud Magazine

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