





**FINITE
RISK
TRANSFER**

By Douglas Simpson

**May Be Habit Forming —
Use Only as Directed**



Finite risk transfer—powerful medicine that can be safe and effective. Possible side effects include civil complaints, criminal indictments, and increased regulation.



FINITE RISK COVERAGE grew out of financial reinsurance in the 1960s. It found an eager market in the 1980s as powerful medicine against various financial ills and became a subject of abuse during the 1990s. In the wake of the Enron and Arthur Andersen scandals, state and federal authorities escalated from civil complaints to indictments alleging secret deals to manipulate financial statements, disguised as legitimate finite risk transfers.

Will increased regulation in the United States help control the abuse of the finite risk “medicine”? Or will it drive the finite risk market to offshore havens with more liberal regulations?

What Is Finite Risk Transfer?

Traditional insurance transfers the underwriting risk of accidents and natural disasters, of liability for negligence or business operations, and of the impact of death or disease. That transfer of underwriting risk is essential for authorities to recognize such coverage as insurance.

Finite risk coverage transfers “timing risk” and provides “risk financing.” In a finite risk deal, the recognition of the time value of money becomes a vital element of the negotiation between customer and seller, and is spelled out in the policy terms. It enables the buyer, hit with a big or unexpected loss, to improve its balance sheet and income statement now, in return for an insurance premium paid to the seller in future years. When the payout curve of the covered loss is long and uncertain, that buys time for a customer to rebuild its finances.

Finite risk deals grew out of financial risk coverages, modified to satisfy insurance and tax regulations. Financial risk covers look much like financial guarantees; they might cover the risk that a borrower won’t repay the bank or the risk that an industrial firm won’t repay the principal and interest on bonds it sold to finance its factory or receivables.

The moral hazard is significant; the seller takes on a risk over which the buyer has a lot of control, and the buyer may be tempted to dump the debt on the seller. Insured defaults may be correlated with general financial downturns that also weaken the insurer’s asset base.

Traditional insurance is more like saving and investing; the customer pays upfront and the seller gets a stream of premiums, plus the knowledge that most customers won’t crash their cars,

torch their businesses, or poison their customers just to collect their insurance. Losses have no natural correlation with financial markets that could affect the insurer’s financial strength.

To avoid insurers and reinsurers being dragged under by financial risk coverage during general financial downturns, regulators may insist that financial risk business be kept separate from traditional insurance business or be written in separate companies. Regulators watch for buyers and sellers attempting to disguise risky credit deals as safer insurance coverage.

The Finite Risk Concoction

The powerful medicine known as finite risk coverage typically combines a mixture of four features.

- First, the insurer or reinsurer accepts just enough traditional risk to qualify the deal as insurance and carefully defines that risk in the insurance policy or reinsurance agreement.
- Second, the coverage is written to cover not one but several policy years, so that an unexpected good or bad loss year can be smoothed out by rebating or surcharging the premium in later years.
- Third, the deal spells out how the insured will share in the loss experience (good or bad) during the extended policy term.
- Finally, the deal provides for the insured to share in the investment income earned on the premium paid.

Combined, the four ingredients keep the traditional risk to a low, predictable, or “finite” level and provide a significant financial benefit to the company buying the coverage.

Unlike traditional insurance or reinsurance, the seller in a finite risk deal protects itself from the buyer flipping to a cheaper provider after the market cycle turns. The multi-year contract,

The World Trade Center disaster drained billions of surplus out of the global insurance network. Enough insurers reduced writings and raised prices to strain the entire market and increase demand for finite risk remedies.

perhaps combined with a refundable security deposit up front, protects the seller from payment default. Sellers didn't need to rely on the customer staying loyal to a long-term relationship.

At the same time, customers who had committed to future payments, hoping to cover the cost from improved results, were locked into the deal, unable to shop for better coverage. Some customers found that they had to buy more medicine when next year wasn't as good as they had hoped. Some customers found that they had to keep buying more every year to avoid the appearance of insolvency, and began taking more and more risks.

Some, in short, were addicted.

Is it Credit or Insurance?

Your accountant wants to know. Like any powerful medicine, finite risk coverage offers a variety of benefits. It may shift the impact of

a known or expected loss from one accounting period to another. It may shift the timing risk if a bundle of long-tail losses has to be paid faster than expected. In the end, the absolute amount of loss paid may be the same for each party as before the coverage was written, but the time at which that loss must be paid has changed for each one. In many practical applications, these deals take the place of loans or lines of credit.

To encourage savings and investment, authorities allow insurance deals to get favorable accounting that's denied to credit deals. The cocktail of benefits packed into a finite reinsurance deal depends on the insurance classification of the transaction. When a customer gets more benefit from an insurance deal than from a debt deal, customer-oriented sellers can and do shape deals to make them fit the customer's tax and accounting needs—even deals that work a lot like a loan but qualify as finite insurance.

Regulators, tax authorities, and financial analysts disapprove of deals that hide a credit remedy in a capsule labeled "insurance." They may order those who mislabel transactions to reach back and rebook them if they lack enough risk transfer to qualify as insurance. However, what makes that capsule of medicine qualify as insurance instead of credit isn't entirely clear. If disqualification and an administrative penalty are the worst things you can expect from the authorities, you might accept a risk of regulatory challenge. After all, nobody's going to jail for this, right?

The Roaring '80s: Boom Times for Finite Risk

When bad things happen, people need medicine. Finite risk remedies are in peak demand during difficult insurance markets, and the liability insurance market of the 1980s was especially challenging. Skittish insurers made prices and capacity volatile; long-tail exposures for pollution liability and occupational lung diseases turned out worse than expected. An underwriting downturn hurt operating ratios and balance sheets, driving many to look for loss portfolio transfers and adverse development covers. New, aggressive insurers saw opportunities to write more business at good prices but lacked the surplus needed to support big increases in premium volume.

Reinsurance companies with deep pockets and long-term perspectives took those financial troubles onto their broad shoulders by writing risk-financing deals that extended over several years, with just enough underwriting risk transfer to satisfy the accountants and lawyers. They provided surplus relief so their customers could write more insurance at better prices without setting off warning bells or buying expensive traditional reinsurance. They enabled mergers and acquisitions that were too risky without



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some retroactive protection for the newly discovered problems in the weakened target companies. They smoothed earnings surprises that depress stock prices and executives' stock options. Their remedy provided fast relief from their customers' pain and stiffness, usually on a "pay me later" basis.

Regulations Require Genuine Transfer of Risk

As the responses to the market developments of the 1980s surfaced, they raised concern among accountants and insurance regulators that transfer of financial timing risks was being improperly handled and accounted for as insurance. In 1992 and 1993, the Financial Accounting Standards Board issued FASB 113 and EITF 93-6, which set accounting rules that required reinsurance to include a significant risk of underwriting loss, not just timing risk, for a deal to qualify as reinsurance. The National Association of Insurance Commissioners agreed on similar rules for Statutory Accounting Practices (SAP) in 1994 revisions to its Accounting Practices and Procedures Manual.

In the United Kingdom, regulators were more flexible in defining a deal that would qualify as insurance. In FRAG 35/94, a "genuine transfer of risk" was called for, with a "significant" risk of loss accepted by the reinsurer. Transferring naked timing risks was allowed, if the economic substance of the transaction was sufficient to qualify it as reinsurance.

In practice, the rules boiled down to a "10/10" rule of thumb: The customer must transfer at least a 10 percent likelihood of a 10 percent loss or damage. In other words, shifting a 1 percent underwriting risk was sufficient to qualify a deal as insurance, no matter how much timing risk transfer was loaded into the capsule of financial medicine. Some aggressive players found ways to leave out even that 1 percent.

Naughty '90s: Abuse Hits the News

Because finite risk deals are designed to postpone and mask bad news, the side effects take time to show up. Reality eventually catches up, as can be illustrated by looking at just a few of the deals made public early in the new century.

In its report on the 1999 financial examination of Gerling Global Reinsurance's 1996 accounting period, the New York insurance superintendent described a series of Berkshire Hathaway "profit treaties" written to smooth out Gerling's heavy underwriting losses. Gerling could produce no underwriting files for the treaties; they would be triggered only by specific extraordinary natural disasters, and the documents were signed after the exposure period was over (and the absence of loss known). The superintendent disqualified Gerling's accounting because it was "unable to demonstrate a transfer of risk for the agreements."

Until 2001, when it was placed into liquidation, HIH Insurance was a leading company in Australia, confident enough to expand into the California workers' compensation insurance market. When it suddenly collapsed, the shock to Australia's economy led to a government investigation and a thick report by Justice Neville

Owen. Owen attributed HIH's corporate death to its acquisition of another company that was addicted to finite reinsurance.

According to the report the Australian government posted on the Internet, HIH had always wanted to buy its competitor, FAI Insurance—so much so that in 1999 it paid \$300 million in cash without any due diligence. When it finally got to look at FAI's books, it found that FAI's management had papered over years of persistent bad pricing and reserving decisions by buying finite reinsurance from Berkshire Hathaway subsidiaries.

The finite risk deals did "smooth" bad results into later years, but the terms practically guaranteed a stream of financial losses for years to come. Justice Owen found that while some transactions had "some risk transfer, albeit not much," in others "there was an attempt to hide the absence of risk transfer and an apprehension that if the full transaction was disclosed then no beneficial accounting treatment could be obtained."

Conflicting Forces Emerge

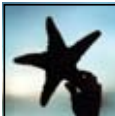
The World Trade Center disaster drained billions of surplus out of the global insurance network. Enough insurers reduced writings and raised prices to strain the entire market and increase demand for finite risk remedies. On the heels of this came the collapse

of Enron and the failure of Arthur Andersen, driving regulators and accounting firms to tighten their scrutiny of obscure financial deals. The Sarbanes-Oxley Act of 2002 dramatically raised the stakes for executives and boards of directors of publicly held companies that failed to disclose risky business.

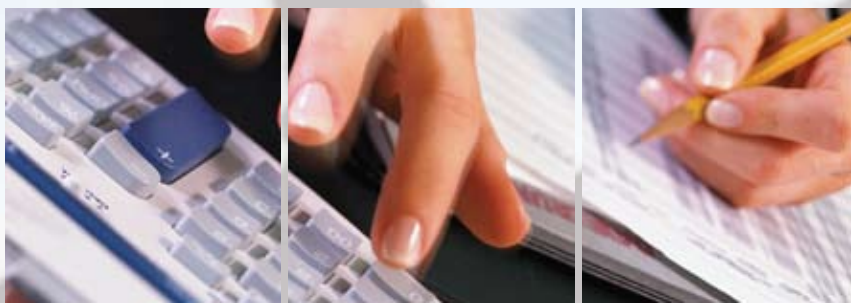
Thoroughly documented insurance collapses in Australia make good reading for scholars, but collapses that hurt doctors and lawyers in Virginia get attention from the United States Justice Department.

In 2003, Reciprocal of America appeared to be a successfully expanding, Virginia-based professional liability insurer of some 7,000 doctors and lawyers. ROA's sudden collapse in that year led to criminal fraud and conspiracy charges and thousands of doctors and lawyers suddenly uninsured against millions in pending claims. Civil racketeering lawsuits by the states of Virginia and Tennessee charged Berkshire Hathaway subsidiary General Reinsurance as an alleged insurance fraud conspirator. According to the suits, Gen Re inflated ROA's surplus through finite risk deals, using secret "eyes only" side letters to avoid any substantial insurance risk while enabling ROA's management to paper over its insolvency and write more business.

As the ROA collapse drew state and federal attention, New



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York Attorney General Eliot Spitzer's investigation of insurance bid-rigging charges expanded to include suspicious reinsurance transactions between AIG and Gen Re. While the Justice Department studied records of ROA's deals with Gen Re and accepted guilty pleas from ROA executives, Spitzer prepared a civil suit against AIG alleging that it used a "riskless transaction" with Gen Re to "falsify reserves" and satisfy concerns of stock analysts.

Early in 2006—its former chair Maurice "Hank" Greenberg gone—AIG paid or wrote down huge sums to settle Spitzer's charges and agreed to cooperate with ongoing state and federal investigations of those selling the remedy. By the time of this writing, with Gen Re's cooperation, SEC suits and criminal indictments were pending against former senior executives of Gen Re, alleging fraudulent schemes to use finite risk transfer deals to mislead investors about AIG's finances.

Fear and Loathing

Time will tell what impact these scandals will have on the finite risk marketplace. Some commentators suggest that the market is dead for the foreseeable future, as the legal risks to management are too high. Others see the market as shifting offshore to regulatory havens like Bermuda, where reinsurers enjoy more liberal

insurance regulation and lower taxes.

Companies that want access to the U.S. capital markets need to plan for SEC jurisdiction and possible scrutiny. The federal indictments coming out of the ROA and AIG cases show that the federal government intends to play a role in this field. As they have in the past, these federal initiatives may stimulate more aggressive action by state regulators who want to preserve state regulation of insurance.

Finite risk transfer is powerful medicine, and can be safe and effective when used as directed. Like other remedies with "feel good now, pay me later" effects, it's tempting to abuse, and when it is, it extracts a high cost from those who surrender to its addictive properties. But overly strict or naïve attempts at regulation can backfire, driving it underground and out of sight offshore, leaving the U.S. insurance market with fewer choices. Regulators and insurance executives face the challenge of preserving a valuable financial tool while controlling the ill effects.

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