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MARKETS

Hidden Loans May Be Common Practice In Insurance Industry

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Insurance companies for years have been buying insurance policies for themselves that are akin to the product at the center of a criminal investigation into whether **American International Group Inc.** helped a cellphone distributor manipulate its earnings.

Critics say the policies are sometimes insurance in name only. That is because the premiums or other payments are so big that the seller assumes little or no risk, making them like loans that help buyers smooth their earnings and shore up their stock price. The reason: Insurance proceeds count as income and offset losses, while a loan must be counted as a liability -- a debt that must be paid off over time.

RISKY BUSINESS


• [Page One: Policing Business on a Shoestring](#)¹
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• [Heard on the Street: Marsh Spells Out First Reforms](#)²
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• [Read the complaint](#)³ filed against Marsh & McLennan. ([Adobe Acrobat](#)⁴ required.)

• [See a reader's guide](#)⁵ breaking down the allegations and insurance-industry lingo being tossed around in Spitzer's case.

In the **AIG** case, securities regulators say cellphone company **Brightpoint Inc.** agreed in 1999 to pay \$15 million in premiums to **AIG** in monthly installments in return for an upfront payment of policy proceeds from **AIG** of \$11.9 million. That helped the Indianapolis company offset a higher-than-expected loss in a trading unit.

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TRACKING THE PROBE

Oct. 14, 2004: New York Attorney General Eliot Spitzer charges Marsh & McLennan with cheating corporate clients by rigging bids and collecting huge fees from major insurance companies for throwing business their way. The civil complaint names insurance companies American International Group, Ace Ltd, Hartford Financial Services Group and Munich-American Risk Partners as participants with Marsh in paying improper fees and bid rigging.

Oct. 15: Marsh replaces the chairman and chief executive of Marsh Inc., its insurance-brokerage unit, but said it didn't reflect on his performance.

Oct. 18: Marsh says it received \$845 million in controversial contingent fees from insurance companies in 2003, more than was previously known.

Oct. 19: Four Marsh employees

New York-based **AIG**, one of the world's biggest financial-services

companies, said last week that it was the target of a criminal grand jury probe focused on the Brightpoint policy and similar products. The company quoted the U.S. attorney's office in Indianapolis as saying the investigation concerns products "that would appear to be insurance and accounted for as insurance, but did not involve any actual risk transfer." AIG has said it is seeking to settle with authorities and that the one-of-a-kind policy earned it less than \$100,000.

This investigation is the latest example of the government targeting financial-services firms that aid corporations in manipulating earnings or balance sheets. Last year, authorities settled with big banks and Wall Street firms that allegedly helped Enron hide billions of dollars of loans. The scrutiny represents a potentially large expansion of this effort. AIG settled Securities and Exchange Commission civil charges over Brightpoint last year.

At the heart of the issue is risk: Normally, an insurer is paid a specific amount of premiums to take on a risk of uncertain size and timing. With policies like the Brightpoint one, and more-complex variations that insurance companies themselves have bought for nearly two decades, the risk of a loss is limited, and sometimes even eliminated. That transforms an "insurance" transaction into one more resembling financing.

The policies bought by insurers are sold by reinsurance companies, which historically have contracted with insurers to take on some of the risk for policies covering everything from lawsuits against corporate officers to workers' injuries to hurricane damage. To some degree, reinsurance is by nature an earnings-smoothing product: Insurers buy it to cap their exposure to claims.

But over the past three years, regulators from Virginia to Australia have raised serious concerns about policies that seem to do little more than dress up the policyholder's financial statements. Only if the reinsurer issuing the policy faces the risk of a significant loss under the arrangement can the policyholder use the more-favorable accounting treatment of reinsurance.

William Yankus, a property-casualty insurance analyst at Fox-Pitt Kelton, a research and investment-banking unit of Swiss Reinsurance Co., said certain of the reinsurance policies, known as finite-risk or financial reinsurance, "are more like window-dressing transactions" for insurers. "The economics over time favor the reinsurer." A loan carrying future payment obligations that is wrongly labeled as insurance proceeds isn't easy to spot, however. Disclosure is murky, at best, so the most questionable policies often surface only during a financial meltdown.

For instance, Virginia and Tennessee regulators are suing General Reinsurance Corp., a unit of **Berkshire Hathaway** Inc. and one of the world's biggest reinsurers, for allegedly selling "sham" policies to a professional-liability insurer in Richmond, Va., that is in insolvency proceedings. The suit, pending in federal court in Memphis, Tenn., alleges the policies were designed to fool regulators into believing the carrier was financially sound when it wasn't.

The lawsuit charges that for years, starting in the early 1990s, insurer Reciprocal of America reassured

whose names have surfaced as part of Mr. Spitzer's investigation are suspended.

Oct. 20: Banks agree to waive until Dec. 30 clauses in their credit agreements with Marsh that would have allowed them to cut off short-term financing agreements due to "material adverse litigation" or issues regarding "compliance with laws."

Oct. 24: Jeffrey W. Greenberg resigns as Marsh's chairman and CEO. He is succeeded by Michael G. Cherkasky, who was once Mr. Spitzer's boss in the New York County district attorney's office. The shake-up averts the possibility that Marsh will be criminally indicted in the case.

regulators that its units had access to millions of dollars in reinsurance through General Re. In fact, regulators say, those assets were debilitating loans, thanks to secret side agreements that required Reciprocal to repay the losses General Re incurred, with interest. Regulators are seeking recovery of those payments. General Re plans to fight the allegations.

Joe Brandon, chairman and chief executive of General Re, called the lawsuits an effort by creditors and others to tap into "deep pockets," and noted other insurers also lost money in the professional-liability sector. General Re lost about \$70 million on Reciprocal's business in 1998, he added.

Separately, an Australian judicial panel last year dubbed the use of reinsurance contracts by HIH Insurance, whose collapse in March 2001 was that country's biggest-ever bankruptcy, as "audacious." The contracts "were structured in such a way as to give the appearance of a transfer of risk when in fact there was none," the HIH Royal Commission concluded.

Some documents were backdated, while side agreements were used to negate risk transfer, the panel said in its final report. The reinsurers included General Re, which declined to comment on the HIH Royal Commission's report.

Even venerable insurance-industry specialists have a tough time deciphering which policies transfer significant risk and which are more akin to loans. Six months after the costly Sept. 11, 2001, terrorist attacks, Dowling & Partners, an independent research firm serving institutional investors, tried to piece together scattered details from a financial filing by insurance businesses of **General Electric Co.** In a March 11, 2002, report, it estimated that a type of financial reinsurance had contributed as much as \$2.5 billion to the company's net income. (GE posted net of \$13.7 billion in 2001.) The report concluded that GE would owe additional premiums because GE's filing suggested that the company hadn't signed the reinsurance contract until after the losses occurred and hadn't yet fully paid for the policy.

After GE complained to the research firm and provided some additional information, Dowling corrected its report, saying the analysis was based partly on inaccurate assumptions. A follow-up report said GE denied owing further reinsurance premiums and said the arrangement had been agreed upon during early 2001. Still, the company did owe some undisclosed sums of money to the reinsurers, though not premiums. Dowling likened the transactions to a loan, and said GE could have gotten a lower borrowing rate using its own stellar credit rating, but that the deals were attractive because of the favorable accounting treatment. GE declined to reveal the rate, but said it was not excessive. Dowling reduced its estimated income-statement benefit to about \$400 million pretax.

A spokesman for GE's insurance operations said the company's reinsurance policies were true risk-transfer agreements, not loans of any type, and that they were fully disclosed and not in any way similar to the Brightpoint policy. GE Global Insurance, in its 2003 annual filing, said that financing charges related to the relevant 2001 and prior contracts was estimated to be \$125 million in 2004. The filing said GE didn't intend to renew the coverage in 2004.

GE's reinsurers included units of Berkshire Hathaway, AIG and European powerhouse Swiss Re, and Scandinavian Re. Speaking generally, Joe Umansky, president of AIG Reinsurance Advisers, said "risk transfer is sometimes subjective," but AIG is "careful that there is sufficient risk transfer" to meet regulatory requirements. A spokesman for **White Mountains Insurance Group Ltd.** said it found no cause for concern

when it looked over Scandinavian Re's book of business before acquiring it. Spokesmen for Swiss Re and Berkshire Hathaway declined to comment.

St. Paul Cos., a predecessor company of **St. Paul Travelers Cos.**, said in a financial filing on March 29, 2002, that it had opted not to use a reinsurance policy in place at the time of the terrorist attacks. St. Paul said the pact had been designed "to reduce the volatility in our reported earnings over time." The company's Sept. 11 loss was so large, however, that its earnings would still be choppy even with the policy. St. Paul's filing said "there would be little, if any, economic value to us in ceding any losses under the treaty." A St. Paul spokeswoman said the contracts were entered into by the company's previous management, starting in 1999, because the company had underwritten business with the potential for large losses in any given quarter. She said the company hasn't purchased such policies in the ensuing years.

About a decade ago, some insurers began selling the products to non-insurance companies. Besides AIG, those include Bermuda-based ACE Ltd., says Andrew Barile, a consultant who designs financial-insurance products for companies. The products sold by the Ace unit are true insurance policies, a spokesman said. "It's got to be a risk transfer, or we don't sell it."

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