Roads to Ruin – How insurance companies fail

Independent Insurance, Equitable Life and AIG

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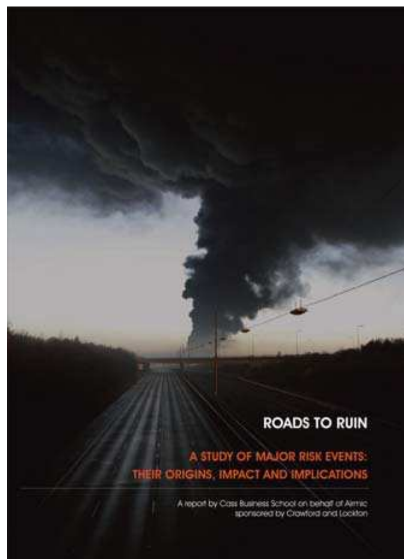
The Insurance Institute of Luton and St Albans

Tuesday 29 September 2015



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Roads to Ruin, a research project undertaken for Airmic, by Cass Business School, sponsored by Crawford and Lockton

The study

- 18 case studies of companies that experienced crises
  - Variety of industries, sizes and types of crises
- Each case study examined:
  - What happened
  - Why it happened
  - How management responded
  - Immediate and longer-term consequences
  - Role of insurance
  - Risk management lessons to be learnt, by specific companies involved, and companies in general

Some key consequences

Impact / Case study	Collapse of company	Government rescue	Chairman &/or CEO lost job	Company &/or senior execs fined	Executives jailed
AIG & AIGFP	✓	✓	✓	✓	✓
Arthur Andersen	✓		✓	✓	
BP Texas City			✓	✓	
Buncefield				✓	
Cadbury Schweppes				✓	
Coca-Cola Dasani UK					
EADS Airbus A380			✓		
Enron	✓		✓	✓	✓
Firestone				✓	

Some key consequences, cont.

Impact / Case study	Collapse of company	Government rescue	Chairman &/or CEO lost job	Company &/or senior execs fined	Executives jailed
HSBC / Zurich / Nationwide				✓	
Independent Insurance	✓		✓	✓	✓
Land of Leather	✓		✓	✓	
Maclaren				✓	
Northern Rock	✓	✓	✓	✓	
Rail disasters	✓	✓	✓	✓	
Shell			✓	✓	
Société Générale			✓	✓	✓
UK Passport Agency			?	✓	
Total	**7**	**3**	**11-12**	**16**	**4**

Main findings - seven common underlying factors

1. Inadequate board skills and the inability of NED members to exercise control
2. Board blindness to inherent risks, such as risks to the business model or reputation
3. Inadequate leadership on ethos and culture
4. Defective internal communication and information flow
5. Organisational complexity and change
6. Inappropriate incentives, both implicit and explicit
7. ‘Glass Ceiling’ effects prevent risk managers from addressing risks arising from top management

Independent Insurance

Centenary: people

The Three Musketeers

Individuals within the insurance market have helped shape its future in recent years. Stephen Womack looks at three of them.

Three very different men have dominated the UK insurance landscape during the 1990s. One, urbane, smooth, seemingly unflappable, brought a 300-year-old institution back from the brink of extinction. A second, gregarious, energetic and forceful, turned a fledgling insurer into one of the nation's most admired public companies. The third saw his simple idea become the most influential force in personal lines insurance. In these distinct ways, Sir David Rowland, Michael Bright and Peter Wood have left their marks on the decade.

Independent, as the company became known, nailed its colours to the broker mast, just when some wondered whether brokers even had a future. The business was built around a series of close relationships and key partnerships with selected brokers, with the emphasis always being on profitable, quality risks.

Sir David Rowland (inset), Peter Wood and Michael Bright

Independent floated in 1993 and is still seen as something of a darling of the stock market. It is now bringing its distinctive style to insurance in France and the US and is dipping a toe into the UK life market.

Journal of the Chartered Insurance Institute, November 1998

… via …

Form 2.21

The Insolvency Act 1986

S.23(1)(a)

Statement of
Administrator's Proposals

Pursuant to Section 23(1)(a) of the Insolvency Act 1986

For official use

To the Registrar of Companies

Company Number
1183179

Name of Company
Independent Insurance Holdings Limited

We, Mark C Batten and Daniel Y Schwarzmann of

PricewaterhouseCoopers
Plumtree Court
London
EC4A 4HT

administrators of the company attach a copy of our proposals for achieving the purposes set out in the administration order filed herein.

A copy of these proposals was sent to all known creditors on:
13 September 2001.

Signed Dated 22.10.2001

Mark C Batten, Joint Administrator, Independent Insurance Holdings Limited

... to one of … The Three Prisoners

Michael Bright	Philip Condon	Dennis Lomas
7 years	3 years	4 years

Southwark Crown Court, October 2007

The Independent Insurance story

- Floated on London Stock Exchange November 1993 at 50p per share
- Michael Bright CEO, Philip Condon Deputy MD, Dennis Lomas FD (from 1996)
- Share price peaked at 400p in December 2000, valuing company at £1 billion, when 9th largest UK general insurance company
- From 2000 Report & Accounts:
  - Gross premiums £830 million; Profits £22 million; Shareholders' funds £316 million
  - Independent is a "*quality operator, well placed in an improving market*" whose unique and long-standing practice of having its reserves vetted by an independent firm of actuaries, Watson Wyatt, continued to provide "*a unique level of comfort to shareholders and policyholders*"

The Independent Insurance story

But meanwhile, behind the scenes:

- Understatement of reserves
  - Off-Claims Systems
    - Reserve increase lists – (estimated as £35.3m by April 2001)
    - 1-4-1 audits of Case estimates
    - Whiteboards – (estimated as £42.5m by April 2001)
- Reinsurance contracts
  - Adverse Development Cover (ADC) in February 2000, £20m premium for £50m of cover
  - Three further Reserve Contracts in March 2001, £110m of premium for £278m of cover – releasing £168m of 'profit' which was booked in the 2000 accounts

The Independent Insurance story

- Reinsurance contracts, cont.
  - However Michael Bright and Dennis Lomas also signed four Pay-Back Contracts, or side agreements, on 2 March 2001, agreeing to reimburse the reinsurer for any losses suffered under the Reserve Contracts
  - Side agreements not disclosed to Board of directors
  - Michael Bright signed Letter of Representation to Auditors, on 5 March 2001, which stated that the Reserve Contracts "*are final and there are no side agreements with reinsurers, or other terms in effect, which allow for the modification of terms under the reinsurance arrangements*"
- Independent's 2000 accounts published on 6 March 2001

The Independent Insurance story

The unravelling

•Michael Bright and Dennis Lomas finally show Garth Ramsay (Chairman) 'schedule zero', detailing the massive hole in the claims reserves

•To survive Independent would need around £220 million of new capital

•Stockbroker expresses concerns about the reinsurance deals

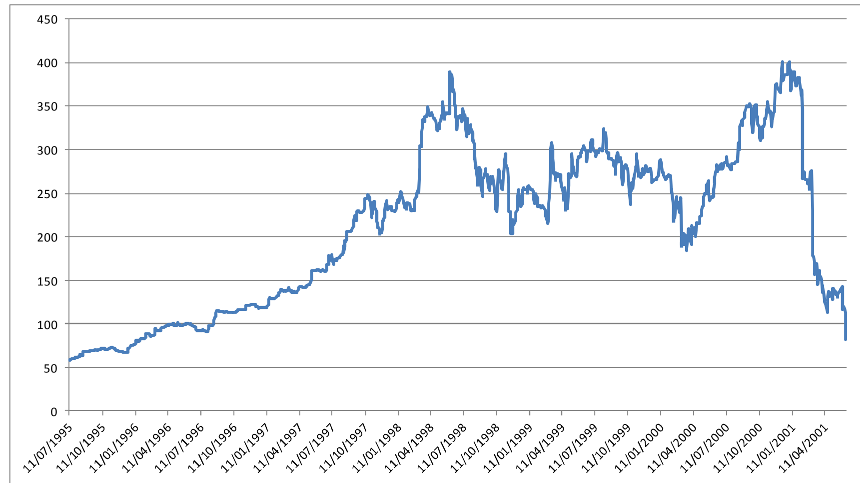
•Ramsay writes to the reinsurer, asking for details of all active contracts

•Reinsurer replies with details of the four Reserve Contracts **and the four secret side contracts**

•Game over!

The Independent Insurance story

Independent Insurance share price



The Independent Insurance story

The consequences

•On 17 June 2001 Independent placed into provisional liquidation
  – 190,000 policyholders and over 50,000 outstanding claims
  – Total cost to FSCS of almost £400 million

•2000 employees lost jobs and all their investments in company Sharesave schemes

•SFO criminal investigation launched
  – Bright, Condon and Lomas stand trial in May to October 2007

•Liquidator sues Independent's accountants, KPMG and actuaries, Watson Wyatt – both settle for undisclosed sums

•FSA writes 'Dear CEO' letter to all UK general insurance companies requesting disclosure on use of financial reinsurance

The Independent Insurance story

Lessons to be learnt

1.Fraud often starts almost innocently, but can then become insidious

2.Danger of a charismatic leader

3.Failure of the iNEDs

a) If things are too good to be true, then …

b) Lack of independence

c) Lack of expertise

4.Don't ignore early warnings signs

5.Say sorry, don't try and parcel out the blame

6.You can't rely on the regulators, actuaries, auditors, credit rating agencies, equity analysts, or whistle-blowers to do your job for you.

American International Group

The AIG story – the two main events

AIG and AIG Financial Products (AIGFP)

•Revelations following an allegedly sham financial reinsurance contract led to the forced resignation in 2005 of AIG's long-term CEO Hank Greenberg and a weakening of its share price and, more importantly, its credit rating

•Two years later large mark-to-market losses on Credit Default Swaps (CDSs) within AIG's subsidiary AIG Financial Products led in 2007 to AIG incurring large book losses and losing its investment grade credit rating, necessitating a rescue operation by the US Government

Summary case study - AIG

Elloit Spitzer - background

- Elected New York State Attorney General in 1998
  - Took up cases including corporate white-collar crime, securities fraud, Internet fraud, and environmental protection – became called the 'Sherriff of Wall Street'
  - Securities (2002) $1.4bn settlement with investment banks for inflating stock prices, spinning IPOs
  - Mutual funds (2003) over $1bn fines for late trading and market timing
  - Richard Grasso (Chairman of NYSE) excessive remuneration
  - Insurance (2004) contingent commissions or 'over-riders' for brokers, and bid-rigging. Also finite insurance products
  - Price fixing (2006) $730m fines for computer chip manufacturers
- Elected Governor of New York in 2006

Financial reinsurance deal between General & Cologne Re and AIG

- 26 Oct 2000 AIG's share price fell 6% on earnings announcement; one reason was decrease in reserves of $59m
- AIG sets up 2x$300m of reinsurance coverage to General Re in return for 2x$250m of premium; AIG pays General Re $5.2m in fees (subsequently repaid to US Government)
  - AIG reported reserves increased by $500m
  - AIG reported written premium increased by $500m
- In 2006 AIG pays $1.6bn to settle civil charges bought by Eliot Spitzer (New York Attorney General) and Securities and Exchange Commission (SEC)
- General & Cologne Re (General Re subsidiary in Dublin)
  - CEO of Cologne Re, Dublin agreed to plead guilty
  - The AIG relationship manager at General Re, also pleaded guilty in Virginia of "conspiracy to falsify SEC filings as part of a scheme to fraudulently enable [AIG] to report increased insurance reserves"

Financial reinsurance deal between General & Cologne Re and AIG

- One AIG and four General Re executives found guilty of conspiracy and fraud in February 2008; subsequently fined (amounts between $100,000 and $250,000) and sent to prison (for between 1 and 4 years); appeals court overturned convictions in August 2011 and new trial ordered
- Joseph Brandon, CEO of General Re, resigned in April 2008
- In Feb 2009 General Re Corp pays $72m to settle investor claims on behalf of three Ohio pension funds (because of decline in AIG's stock price)
- In August 2009 Hank Greenberg, former CEO of AIG, pays $15m to settle SEC charges that he altered AIG's records to boost results between 2000 and 2005
- General Re agrees to pay $92.2m to end investigations into its role in transactions that allegedly defrauded AIG investors

Summary case study - AIG

Lessons to be learnt

1.Senior management should pay attention to the upside risks, not just the downside risks, coupled with the risk of a lack of understanding of the business by top managers and the Board

2.Beware of the cult of the personality
- Hank Greenberg
- Joseph Cassano

3.Failure of the non-executive directors

4.Insurance risks are not the same as banking risks

5.Excessive use of offshore vehicles

6.Alignment of risk and remuneration – the curse of the trader's option

7.Post-crisis reputation management

Equitable Life

The Equitable Life story

- Formed in 1762, pioneer of scientific life underwriting
- In 1957 introduced new with-profits pension product, which included option to obtain an annuity at guaranteed rate (GAR)
- At this stage Equitable regarded as "*a small conservative with-profits life office*"
- Embarked in sales growth strategy mid 1960s to late 1990s, to become one of three biggest pension providers
- GAR removed from new policies in 1988
- 'Full and fair' distribution of profits – but low 'free asset ratio'
- October 1993 market rates fell below GAR, so Board reduced terminal bonuses for GAR policyholders to compensate

The Equitable Life story

- Problems with potential GAR liabilities and differential bonus solution exposed in press in August 1988
- Equitable assumed reserve cost of £50m to £200m, but new FSA rule meant reserves would have to be £1.5bn
- Bought financial reinsurance to put £800m on Balance Sheet
- Equitable took test case (Hyman) to High Court, but lost
  - Gave rise to additional liabilities of £1.5bn
  - Financial reinsurance contract invalidated
- Then also transpired that Equitable's assets were £3bn less than previously advised
- Equitable closed to new business in December 2000
- Many reports and official inquiries before £1.5bn compensation scheme finally agreed in October 2010

The Equitable Life story

Summary

•Equitable was underfunded and had little capital

•It had guaranteed fixed returns to policyholders, but had not reserved / reinsured / hedged against adverse market conditions

•Management ignored early warning signs and were reluctant to admit or address the problems because it would have had serious repercussions on new business growth

•"*They made only one mistake. It wasn't such a great mistake either, but the unique way they ran the business meant they could never afford to make any mistake.*" (CEO of a rival company)

•Many reports and official inquiries before £1.5bn compensation scheme finally agreed in October 2010

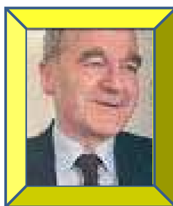
The Equitable Life story

Lessons to be learnt

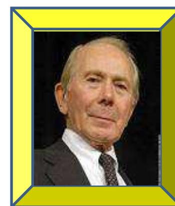
- Dominant CEO, Ray Ranson – was also Chief Actuary (no checks and balances)
  - “*idiosyncratic and autocratic*”, and “*domineering figure who brooked no dissent*” (Penrose report, 2004)
- Ineffective NEDs
  - “*did not understand the risks to which the Society was exposed*”, and had “*a poor understanding of the Society’s developing financial position*”, being “*ill-equipped to manage a life office by training or experience*” and “*incompetent to assess the advice objectively and challenge the actuaries*”
- Other factors:
  - Complexity of product (with-profits life policies)
  - Failure of prudential supervision
  - Hubris – taking Hyman case to court

Insurance CEO “Hall of infamy”

Michael Bright
CEO Independent

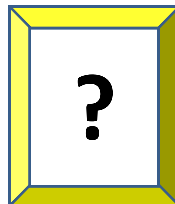


Ray Ranson
CEO Equitable



Hank Greenberg
CEO AIG

Joe Cassano
CEO AIGFP



Characteristics of long-lasting insurers

- Management acts as steward of the enterprise
  - Objective is to pass on in healthy form to next generation of management and policyholders
- Management incentives (financial & operational) are strictly aligned with principal stakeholders
  - Customers, brokers, employees, shareholders, community
- Management is knowledgeable
  - No less knowledgeable about industry trends, opportunities and threats than larger competitors

From a presentation by Dr Bob Hartwig, Insurance Information Institute

Characteristics of long-lasting insurers, cont.

- Company is nimble: environment for small insurers can and does change
  - Not always first to change, but adaptation occurs as necessary within reasonable timeframe
- … but lacks a ‘wandering eye’
  - Disciplined enough to stick to business its knows
- Intuitive and comprehensive knowledge of ERM
  - Practised it before it well before it had a name
- CEO is willing to seek advice and counsel
  - Listener and consensus builder

From a presentation by Dr Bob Hartwig, Insurance Information Institute

Topic for discussion:

What are some of the features of their business models that make insurance companies different and prone to problems?

Some of the ways in which insurance companies are different

- Nature of product
  - Exposure is long-term (even sometimes for non-life covers)
  - Uncertainty of outcome – ultimate product cost not known at time of sale (lag between premium and claims)
  - Asymmetry of information and understanding between insurer and policyholder
  - Accounting is complex – cash is not profit
- Nature of market
  - Insurance pricing is cyclical
  - Growth is difficult – market is largely undifferentiated and very competitive

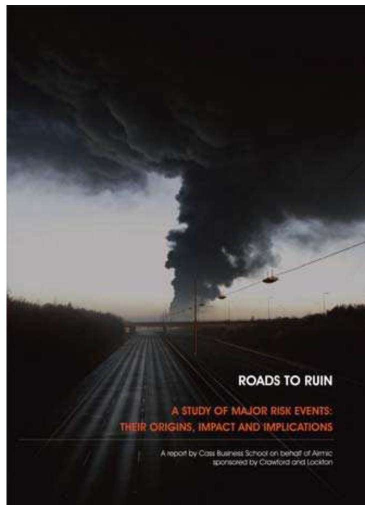
Lessons not all learnt yet!

No shortage of further case studies, for example:

- **BP Deepwater Horizon** (explosion and pollution)
- **Toyota** (product recalls)
- **HBOS** (government rescue)
- **News Corporation** (phone hacking)
- **Olympus** (corporate governance failings)
- **Carnival Cruises** (Costa Concordia sinking)
- **MF Global** (trading losses)
- **Tokyo Electric Power Company** (tsunami)
- **Nat West** (IT failure)
- **UBS** (rogue trader)
- **RBS** (government rescue)
- **JP Morgan** (trading losses, London whale)
- **Barclays et al** (LIBOR scandal)
- **GlaxoSmithKline** (illegal drug marketing, China)
- **RSA** (reserving in Ireland)
- **Quindell** (?)
- **CO-OP** (governance failings)
- **Tesco** (horsemeat & profit reporting)
- **SONY** (hacking)
- **Towergate** (expansion)
- **Petrobras** (bribery)
- **Tesco** (accounting)
- **HSBC** (tax evasion)
- **VW** (emissions testing)
- & even **BofE** (forex trading)

- Etc. etc.

Thank you – any questions?



Main body of report, 24 pages, available free to download from www.airmic.com

The full 183 page report, main body plus all the 18 case studies, can be purchased from Airmic (in hard copy or pdf format)

Contact: alan.punter@gmail.com

Appendix
Roads to ruin – Summary of lessons

Summary of lessons

1. **Board skills and NED control (or dysfunctional Boards)**
   - **The Board and Non-Executive Directors (NEDs) not being in effective control of the business**
     - For instance, the Board of **Northern Rock** did not seem to understand or question the fatal flaw in their business model of over-reliance on the wholesale money market.
     - Dominant CEOs running rough-shod over the Board, such as in the cases of **AIG**, **Enron** and **Independent Insurance**.
   - **Leaders or NEDs as a whole lacking the skills necessary to exercise oversight of the business**
     - For instance, the NEDs of **Enron** and **Independent Insurance** do not appear to have challenged how the business was achieving exceptional results, before the frauds became apparent for other reasons.

Summary of lessons

2. **Board risk blindness**
   - **The Board not focussing on important risks, including threats to the company's reputation and 'licence to operate'**
     - For instance, **Railtrack** jeopardised its safety reputation and ultimately lost its 'licence to operate' because it subcontracted its key track and maintenance operations.
   - **The Board not setting and controlling risk appetite**
     - For instance, **EADS Airbus** using new and unstandardised technology to design and construct the A380. Whereas, in contrast, **Coca-Coca** made the decision within 24 hours to withdraw the troubled UK launch of Dasani, rather than risk further damage to the Coca-Cola reputation.
     - Or inappropriate incentives, whether explicit or implicit, such as the cases of **Arthur Andersen** (more interested in generating consultancy fees than being strict on Enron's audit), **BP** (just 15% of bonus linked to safety, 70% to financial performance), **Shell** (executive bonuses linked to oil reserve estimates).

Summary of lessons

2. **Board risk blindness, cont.**
   - **Failure to appreciate the risks presented by complexity, both as a cause of cause and exacerbation of events**
     - For instance, the **EADS Airbus A380** project involved complexity of product design, IT systems, manufacture and assembly, exacerbated by the political demands to share work 'fairly' between the operations in France, Germany, Spain and UK, and to share power in a Franco-German management structure (for example with two CEOs, one from each country).
     - The **Texas City refinery** explosion was partly the result of BP's merger with Amoco and the failure to rationalise the management structure and integrate the safety cultures. In major M&As, doing the deal is the exciting part; completing the integration of management structure and operations is much less exciting and a long slog.

Summary of lessons

3. **Failure of Board leadership and implementation on ethos and culture**
   – **The Board did not set and universally apply an adequate and coherent business and moral compass**
     - Many examples, such as **Arthur Andersen** not challenging Enron's accounting methods because it wanted to get more consultancy fees, and then cynically applying its document shredding policy as soon as trouble loomed.
     - **Shell** preaching ethical leadership whilst exaggerating oil reserves to boost leader's bonuses. Such a perception of 'double standards' was present in the **Maclaren** US and UK pushchair recalls, and **SocGen's** apparent earlier tolerance of Jérôme Kerviel's rogue trading.

   – **The Board failed to create and embed throughout their organisation a coherent strategy on safety matters**
     - For instance, an inadequate safety culture was the underlying cause of the crises at **Buncefield**, **Railtrack** and **BP Texas City refinery**.

Summary of lessons

4. **Defective flow of important risk information**
   – **Both across the organisation and from bottom to top**
     - For instance, **BP** was criticised following the **Texas City refinery** fire & explosion for failing to absorb the lessons from previous incidents at its Grangemouth refinery.
     - At **EADS Airbus** design and construction problems on the A380 were suppressed for 6 months before being passed up to senior executives.

   – **More generally there appears to be a risk 'glass ceiling', with often an inability or unwillingness of risk management and internal audit to report on risks to the C-suite and NEDs, particularly risks arising from strategy, behaviour and culture (as opposed to operations)**
     - Senior staff at **Independent Insurance** appear to have quietly left the company rather than report their concerns to NEDs, auditors or regulators.
     - Warning signs detected by internal compliance at **SocGen** do not seem to have been taken note of at Board level.

What needs to be done?

1. Extension of skills of some risk professionals to be - and feel - competent to identify and analyse risks emerging from their organisation's ethos, culture and strategy, and their leaders' activities and behaviour …
2. … and raised status so they can report and discuss all they find on these matters at all levels, including Board level.
3. Rethink from Board level down of scope, purpose and practicalities of risk management to capture emerging risks not identified by current techniques …
4. … and Boards, particularly Chairmen and NEDs, need to recognise the importance of these emerging risks.