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Wall Street Banks - Reserving Issues

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Introduction

- Impact on Wall Street Banks of:
  - Enron
  - Laddering
  - Worldcom
- Coverage issues
- Loss reserving approach for FI accounts

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Out-of-Scope

- D&O exposure
- Attorneys, accountants, etc..
- Mutual Funds (market timing)
  http://www.casact.org/coneduc/CLRS/2004/handouts/morabito3.ppt
- Parmalat
- Other Financial Institutions losses

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Enron - Background

- Allegation of Enron scheme to boost its share price
- Scheme allegedly worked in 3 ways:
  - Special Purpose Entities (SPEs)
  - Misrepresentation of success in certain areas
  - Hiding loans as energy trades and pre-pay transactions
- Enron re-stated $1bn earnings @q3 2001 and filed for chapter 11 protection in December 2001

Enron – SPE allegations

- Under GAAP, can record gains and losses from transactions with qualifying SPEs without consolidation
- To qualify, independent third party makes at least 3% investment in SPE and exercise control
- From 1998 to 2001 Enron accountants, lawyers and bankers created many SPEs which were controlled by Enron
- SPEs disguised debt by purchasing assets at inflated prices from Enron

Enron – Success and pre-pay allegations

- Enron and its banks represented that certain Enron entities were highly successful (EES, EBS and Newpower) but were actually loss-making
- Banks colluded with Enron to disguise loans as pre-pay transactions; Enron booked loans as trades to boost cash flow and earnings

Enron – IB allegations

- IBs issued false registration statements for Enron-related securities offerings
- Structured and financed non-qualifying SPEs
- Advanced funds to SPEs at key times to create false profits and conceal debt
- Issuing false and misleading reports on Enron

Civil Litigation

- Consolidated securities class action: Texas
- Consolidated ERISA and RICO action: Texas
- Securities action for Retirement System of Alabama: Alabama
- Investors in Newpower: New York
- Individual actions by institutional investors in debt instruments

Banking Defendants in SCA

- Others include D&O's, attorneys,..

Original list

- J. P. Morgan Chase & Co.
- Citigroup, Inc. and its subsidiary, Salomon Smith Barney, Inc.
- Credit Suisse First Boston
- Canadian Imperial Bank of Commerce
- Bank of America Corp.
- Merrill Lynch & Co.
- Barclays PLC
- Lehman Brothers Holding, Inc.
- UBS Pain Webber, Inc. and UBS Warburg, LLC
- *Deutsche Bank AG - dismissed from action December 2003*
- Goldman Sachs

Added in January 2004

- Toronto Dominion
- Royal Bank of Scotland incl. National Westminster
- Andrews & Kurth (Attorneys)
- Millbank Tweed (Attorneys)

Enron - Neil Batson's reports

- Court-appointed bankruptcy examiner 1000 page report – his firm have billed $100m to bankruptcy estate
- Concluded evidence indicates that the IBs investigated were aware of Enron's "wrongful conduct" and "aided and abetted" Enron in conducting accounting fraud

SEC pre-pay settlements

- JPM Agreed to pay SEC $135M (07/03) in disgorgement, penalties and interest plus $25M in penalties and $2.5M in costs related to pre-pays.
- Citigroup (07/03) $120M in disgorgement, interest and penalties, plus an additional $25M and$0.5M in expense reimbursement.
- Merrill Lynch (02/02) $80M in disgorgement, fines and penalties for its participation in two pre-pays; SEC also filed civil actions against 4 ML staff.
- CIBC (12/03) $80M as above; SEC also filed civil actions against CIBC staff.

Other JP Morgan decisions

- Settled (1/03) with 11 Surety companies for 60% on the $1Bn claimed on the Mahonia SPE. Sureties bonded gas-forward advance contracts that they alleged were ‘disguised loans’.
- Won case (8/04) in London High Court against WestLB who refused to honour LOC on grounds that energy-based swap it covered was ‘disguised loan’ made to help Enron inflate profits. Judge said “no dishonesty” on part of JP Morgan.

Enron – Reserving Issues

- Contribution from other non-IB involvements
- Coverage defences include:
  - Intentional misconduct; Single Act vs Multiple;
  - Non-disclosure; Excessive fees and commissions
  - Investment Banking exclusion
- Liability defences for IB

Enron - Reserving approach

- Market settlement assumption
- Discount for contribution by non-IB
- Allocate losses to individual IBs using proxy for relative culpability
- Discount for coverage defences

Laddering - Introduction

- Securities class action lawsuits related to the allocation of shares by IBs with allegations of:
  - Tie-in agreements under which investors were required to buy shares in immediate after-market for favourable allocations
  - Hyping new securities by analysts
  - Undisclosed commissions and kick-backs for preferential allocations
  - "Spinning" – allocation of IPOs to CEOs in return for IB business
  - "Flipping" - IBs encouraged churning of IPO after-market sales between its clients

Some quotes

From Scheindlin's report

These cases allege "an industry-wide scam . . .whereby people were put into IPOs, the stock was hyped, the insiders got out, and the little people who bought [the stock] on their broker's recommendations were left holding the bag. That's the guts of what these cases are coming down to."

[9/26/01 Tr. at 17 (Statement of Jeffrey Barist, counsel to Deutsche Banc Alex.Brown).]

Source:http://www.nysd.uscourts.gov/courtweb/pdf/D02NYSC/03-01555.pdf

IPO litigation

<u>Civil actions</u>

- IPO Allocation consolidated class action for 309 issuers
  - settlement agreement with D&O insurers of issuers

<u>Regulatory Actions</u>

- Global Analyst Settlement

- Securities act 1933 - misleading offering statements
- Exchange Act 1934 10(b) - manipulation of secondary market
- SEC Rule 10b-5 - deceptive and manipulative practices

Civil Actions - D&O Insurers settlement

- Insurers of the 309 issuer companies
- If IBs settle for more than $1bn D&O insurers do not have to pay, but if less then D&O insurers make up the short-fall
- Issuers co-operate in litigation against IBs
- Issuers have assigned rights of recovery of certain claims against IBs to the plaintiffs
- D&O insurers may recoup defence costs if IB settlement exceeds $5bn

SEC global analyst settlements (28/4/03, 26/8/04)

- IBs settled with SEC on 'Analyst' allegations
- No admission of wrong-doing
- Agreed to separate Investment banking and Research functions.
- "Spinning" voluntarily banned
- Civil actions may use settlements as "smoking gun"

- Source: http://www.pbs.org/wgbh/pages/frontline/shows/wallstreet/fixing/settlement.html

Global Settlement - Analyst

Payments in Global Settlement Relating to Firm Research and Investment Banking Conflicts of Interest $'M

Firm	Penalty	Disgorgement	Independent Research	Investors Education	Total
Citigroup/SSB	150.0	150.0	75.0	25.0	400.0
CSFB	75.0	75.0	50.0	-	200.0
Merrill Lynch	100.0	-	75.0	25.0	200.0
Morgan Stanley	25.0	25.0	75.0	-	125.0
Goldman	25.0	25.0	50.0	10.0	110.0
Bear Stearns	25.0	25.0	25.0	5.0	80.0
J.P. Morgan	25.0	25.0	25.0	5.0	80.0
Lehman	25.0	25.0	25.0	5.0	80.0
UBS	25.0	25.0	25.0	5.0	80.0
Piper Jaffray	12.5	12.5	7.5	-	32.5
Total	487.5	387.5	432.5	80.0	1,387.5

Payment made in prior settlement of research analyst conflicts of interest with the states securities regulators

SEC analyst settlements – coverage issues

- IBs agreed not to seek reimbursement for the fines element
- Other damages are 'cost of doing business' - uninsured
- Following Vigilant/CSFB judgement on appeal (16/9/04) disgorgement and associated defence costs uninsured.

Worldcom - Background

- Re-statement of income for 2001 and q1 2002
- $4bn of day-to-day expenses accounted as investments and capital expenditure
- Claims against IBs
  - by bond investors who claim that the IBs did insufficient investigation of Worldcom's finances and should have informed investors
  - False promotion of Worldcom bonds and shares

Worldcom – proposed settlement

	$'M	
Citigroup	2,650	settled 10/05/2004
JP Chase Morgan	1,200	
Bank of America	400	
Deutsche Bank	240	
ABN Amro	320	
Lehman	62	
BNP Paribas	30	
Caboto	30	trial for these 10/1/05
Fleet	30	
Mizuho	30	
Blaycock & partners	25	
CSFB	13	
Tokyo Mitsubishi	10	
West LB	10	
Utendahal	8	

Coverage Issues - Insurance

- Definition of “Loss”
- Deliberate or Criminal Acts
- Consent and Cooperation clauses
- Activities excluded
- Single or Multiple losses

Definition of Loss

- Fines, penalties and disgorgement in settlements with regulators are (probably) not recoverable.
- CSFB tried to recover the disorgement element on the ‘Kick-back’ settlement with SEC but disallowed because ‘disgorgement’ was intended to recoup ‘money that it obtained improperly’

Deliberate or Criminal Acts

- The various alleged ‘Laddering’-related acts were done deliberately to enrich the Banks.
- Some of these are alleged to be illegal
- Many courts don’t allow awards due to such actions to be recovered from insurers as a matter of public policy.
- New York law apparently allows a defendant to recover damages from insurers as long as it didn’t INTEND to injure the plaintiffs

Consent and cooperation clauses

- Insurance policies (normally) include a clause that requires that the Banks obtain the consent of the Insurers before making a settlement that would be insurable.
- Insurers are disputing whether any 'Global Analyst Settlement' amounts are covered as they were not involved in the settlement negotiations

Activities excluded

- Some banks' insurance policies exclude 'Investment banking activities'
- Typically coverage is for 'Professional Services'. It is questionable whether Analyst misstatements or Kick-back arrangements are a 'professional service'.

Single or multiple losses

Insurance coverage is typically

- Each and Every deductible ($25M, say)
- $L xs $D in the aggregate (several layers)
- N reinstatements
- For period affected many banks had 3-year deals 1998-2001 with no reinstatements over the period

- Vigilant and others assert that each issuer constitutes a separate loss - so deductible applies to each, but up to $L of cover available each loss, subject to aggregate limits
- If construed as a single loss then can only recover up to $L

Coverage issues - reinsurance

Single or multiple losses?

- Even if each issuer is a separate loss for insurance purposes could insurers aggregate all laddering related claims for reinsurance purposes?
- 'Sole judge' clauses typically leave it up to the insurer to decide on this. Presumably each insurer could make the decision based on which was preferential to them

Claims cooperation

- these may be absent from (soft market) reinsurance wordings so reinsurers may be forced to 'follow the fortunes' of insurers
- claims cooperation clauses generally absent from reinsurance contracts around 2000/1

Reserving issues - civil actions

There are a range of scenarios

- Dismissed (unlikely)
- Trial proceeds to judgement, damages awarded - appeal?
- Some or all defendants settle out of court (likely)

Impact on insurance will depend on

- if go to trial judgement - how damages are defined
- if settle out of court - whether insurers agree to settle (claims cooperation) - more lawsuits?
- Insurers and banks agree compromise settlement (most likely?)

Reserving issues

- Uncertainty
- Discovery - if insurers carry explicit reserves could these be taken as an admission of liability?

A reserving methodology

- Get list of defendants and identify policy exposures
- Check policy wordings for coverage issues
- Estimate the amount that each defendant will settle - is each litigation/settlement per defendant a separate loss?
- Apply this to the insurance programme
- Make allowance for other claims eroding aggregate limits - estimate which claims will materialise - important to allow for claims which could be reinsured
- Apply to reinsurance programme (if any)
- Reinsurers should do this by cedant with adjustment for missed exposures
- Sensitivity test by varying assumptions

A reserving methodology: Step 1

Bank	Laddering %	Enron %	Worldcom %					$M
A	5%	15%	5%					
B	5%	0%	2%					
Others	90%	85%	93%					
Total Bank	**Laddering Amount**	**Enron Amount**	**Worldcom Amount**	**Other1 Amount**	**Other2 Amount**	**Other3 Amount**	**Other4 Amount**	
A	125	750	200	100	70	50	40	
B	125	70	80	80	70	50	20	
Others	2,250	4,250	3,720					
Insured part of Global Settlement	2,500	5,000	4,000	Settled already				

NB: Figures for demonstation of principle only

- Banks A,B… are the defendants identified
- Estimate their share of the insured element of any global settlement
- Estimate size of global settlement
- Work out implied share in $
- Bank B has settled its Enron exposures @ 70M
- Allow for other claims - how? - these may include LEW not included in Global settlement

A reserving methodology: Step 2

Company A

Insurance Program

	Limit Excess	Deduct	Reinst		Share	1st	2nd	3rd	Total
	50	50	2	1.0%	50	50	35	135	
	150	100	2	1.0%	150	150	-	300	
	200	250	2	1.0%	200	200	-	400	
Prog Lim	400								

	Laddering	Enron	Worldcom	Other1	Other2	Other3	Other4	etc..
Retention	25	25	25	25	25	25	25	
Out top	-	275	-	-	-	-	-	
To insurance	100	450	175	75	45	25	15	
Total	125	750	200	100	70	50	40	

	Program	Share	
Total Claims	1,335		
e.e.l. retained	175		
e.e.l. out top	275		
Amount before Agg limit	885		
Agg Limit	1,200	12.0	
Loss to program	835	8.4	estimated ultimate
Above agg limit	-		
Cover remaining	315	3.7	
Per risk limit	400	4.0	this is the max line - overlined?

- Deduct excess from each loss
- Cap each claim at limit of program
- Sum capped claims
- Apply to layers - when first 'round the clock' reinstatement used up start again at the first layer (most have none)
- If aggregate limit exceeded order of application of loss could affect reinsurance
- Sum across all insureds

A reserve methodology - issues

Are laddering losses one event or up to 309?

- Will it vary by bank, either due to wording or their preference - can they change their minds?
- Is reinsurance on same basis?
- Sensitivity test assumptions and note high potential variability
- Adjust for data collection problems

Conclusion