Introduction

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

Out-of-Scope

- D&O exposure
- Attorneys, accountants, etc..
- Mutual Funds (market timing)
- Parmalat
- Other Financial Institutions losses
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.
   - Lehman Brothers Holdings, Inc.
   - UBS Pain Webber, Inc. and UBS Warburg, LLC
   - Deutsche Bank AG - dismissed from action December 2003

   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).]

IPO litigation

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

Regulatory Actions
- 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”

Global Settlement - Analyst

<table>
<thead>
<tr>
<th>Bank</th>
<th>Penalty</th>
<th>Engagement</th>
<th>Research</th>
<th>Disgorgement</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citigroup/SSB</td>
<td>150.0</td>
<td>150.0</td>
<td>75.0</td>
<td>25.0</td>
<td>400.0</td>
</tr>
<tr>
<td>CSFB</td>
<td>75.0</td>
<td>50.0</td>
<td>-</td>
<td>-</td>
<td>200.0</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>100.0</td>
<td>-</td>
<td>75.0</td>
<td>25.0</td>
<td>200.0</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>25.0</td>
<td>75.0</td>
<td>-</td>
<td>-</td>
<td>125.0</td>
</tr>
<tr>
<td>Goldman</td>
<td>25.0</td>
<td>50.0</td>
<td>10.0</td>
<td>-</td>
<td>110.0</td>
</tr>
<tr>
<td>Bear Stearns</td>
<td>25.0</td>
<td>25.0</td>
<td>5.0</td>
<td>-</td>
<td>80.0</td>
</tr>
<tr>
<td>J.P. Morgan</td>
<td>25.0</td>
<td>25.0</td>
<td>5.0</td>
<td>-</td>
<td>80.0</td>
</tr>
<tr>
<td>Lehman</td>
<td>25.0</td>
<td>25.0</td>
<td>5.0</td>
<td>-</td>
<td>80.0</td>
</tr>
<tr>
<td>UBS</td>
<td>25.0</td>
<td>25.0</td>
<td>5.0</td>
<td>-</td>
<td>80.0</td>
</tr>
<tr>
<td>Piper Jaffray</td>
<td>12.5</td>
<td>7.5</td>
<td>-</td>
<td>-</td>
<td>32.5</td>
</tr>
</tbody>
</table>

Total Payments: 1,387.5 million

Payments 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

<table>
<thead>
<tr>
<th>Firm/Group</th>
<th>Amount ($)</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citigroup</td>
<td>2,650</td>
<td>settled 10/05/2004</td>
</tr>
<tr>
<td>JP Chase Morgan</td>
<td>1,200</td>
<td></td>
</tr>
<tr>
<td>Bank of America</td>
<td>400</td>
<td></td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>240</td>
<td></td>
</tr>
<tr>
<td>ABN Amro</td>
<td>320</td>
<td></td>
</tr>
<tr>
<td>Lehman</td>
<td>62</td>
<td></td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>Caboto</td>
<td>30</td>
<td>trial for these 10/1/05</td>
</tr>
<tr>
<td>Fleet</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>Mizuho</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>Belarusi &amp; partners</td>
<td>23</td>
<td></td>
</tr>
<tr>
<td>CSFB</td>
<td>1 (</td>
<td></td>
</tr>
<tr>
<td>Tokyo Mitsubishi</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>West LB</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>Utendal</td>
<td>8</td>
<td></td>
</tr>
</tbody>
</table>
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 disgorgement 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 xx $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

- 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

<table>
<thead>
<tr>
<th>Bank</th>
<th>Laddering Share</th>
<th>Enron</th>
<th>Other1</th>
<th>Other2</th>
<th>Other3</th>
<th>Other4</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>125</td>
<td>750</td>
<td>200</td>
<td>100</td>
<td>70</td>
<td>50</td>
<td>40</td>
</tr>
<tr>
<td>B</td>
<td>125</td>
<td>70</td>
<td>80</td>
<td>80</td>
<td>70</td>
<td>50</td>
<td>20</td>
</tr>
<tr>
<td>Others</td>
<td>2,250</td>
<td>4,250</td>
<td>3,720</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Insured part of 2,500 5,000 4,000 Settled already

NB: Figures for demonstration of principle only

A reserving methodology: Step 2

- 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

<table>
<thead>
<tr>
<th>Company A</th>
<th>Insurance Program</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limit</td>
<td>Deduct</td>
</tr>
<tr>
<td>Excess</td>
<td>25</td>
</tr>
<tr>
<td>Share</td>
<td>1%</td>
</tr>
<tr>
<td>1st Layer</td>
<td>50</td>
</tr>
<tr>
<td>2nd Layer</td>
<td>50</td>
</tr>
<tr>
<td>3rd Layer</td>
<td>35</td>
</tr>
<tr>
<td>Total</td>
<td>125</td>
</tr>
<tr>
<td>Prog Lim</td>
<td>400</td>
</tr>
</tbody>
</table>

Laddering Share | Enron | Other1 | Other2 | Other3 | Other4 | Total |
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>125</td>
<td>750</td>
<td>200</td>
<td>100</td>
<td>70</td>
<td>50</td>
</tr>
<tr>
<td>B</td>
<td>125</td>
<td>70</td>
<td>80</td>
<td>80</td>
<td>70</td>
<td>50</td>
</tr>
<tr>
<td>Others</td>
<td>2,250</td>
<td>4,250</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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?
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