Way Station

Lots of reinsurance payments—but maybe not much risk— sluiced through a Bermuda reinsurer

BY JONATHAN R. LAING • In the mushrooming investigation into fraudulent finite reinsurance schemes, Inter-Ocean Holdings Ltd. certainly lacks the name recognition of such companies as Warren Buffett’s General Re, American International Group (ticker AIG) and bond insurer MBIA (MBI). For one thing, Inter-Ocean isn’t publicly traded. Instead, it’s owned by a clutch of 11 insurance and reinsurance companies (see table). For another, Inter-Ocean keeps a low profile, with small offices in Bermuda from and Ireland. Any client that wants to do business with Inter-Ocean must be introduced to it by one of its shareholders or companies, which must also agree to fully reinsure Inter-Ocean itself on the new client’s business. In effect, Inter-Ocean is only a way for years, hundreds of millions of dollars of finite reinsurance premiums for its shareholders companies.

But Inter-Ocean’s anonymity is fast disappearing, even though its shareholders recently decided to stop putting new business through it. The decision came after one of its shareholders, RenaissanceRe (RNR), received subpoenas two months ago from the Securities and Exchange Commission and New York Attorney General Elliot Spitzer for information on two reinsurance deals it did with Inter-Ocean back in 2001 that an internal RenaissanceRe investigation found had been improperly accounted for. As a result of the company probe, RenaissanceRe restated its financial results from 2001 through 2003. And this could be just the tip of the iceberg. For Inter-Ocean has long been a key player in the offshore global reinsurance market, a bazaar in which participants, according to people familiar with the industry, apparently have played “pass the trash” with much more ease and finesse. Inter-Ocean, in fact, does nothing but finite reinsurance, which can deliver seemingly magical increases in the earnings, underwriting results and net worth to insurance companies availing themselves of the company’s services. Inter-Ocean’s usefulness arises from its location: Bermuda. Unlike their peers in the U.S. and most of the European Union, Bermuda-based insurers would be required to do. Instead, they put up maybe $800 million on $1 billion of future claims. This leniency is based on the time value of money.

This “discounting of reserves” offered by offshore outfits like Inter-Ocean can do wonders for the financials of U.S. and European insurers. Using the above example, by simply running $1 billion of claims through an offshore reinsurer like Inter-Ocean, a domestic carrier can get an immediate $400 million boost in its underwriting profitiability and pro-tax net income. Likewise, the insurer’s net worth (or, in insurance jargon, capital and surplus) will get a $400 million facelift by the insurer being able to offset a $500 million premium payable (to the reinsurer) on the liability side by a $1 billion claims recoverable (from the reinsurer) on the asset side. It’s not illegal for a domestic insurer to employ such “regulatory arbitrage” to gussy up its financials. Inter-Ocean and others are known in the trade as “transformers” for the accounting alchemy they regularly perform.

But to qualify for favorable insurance accounting, the finite reinsurance deals must transfer a true risk of losses on the reinsured policies. In other words, the reinsurer must be exposed to the possibility of losing money, either because the unit of Inter-Ocean’s shareholder companies to another unit of the same company in another domicile. There was no risk transfer, since the same company was on both ends of the operation.

RenaissanceRe is under investigation for just such a reinsurance transaction through Inter-Ocean. According to the company’s recent 10-K, an internal investigation revealed that RenaissanceRe had entered into two reinsurance deals with Inter-Ocean in 2001 that lacked the “necessary risk transfer” to qualify for insurance accounting. One was an excess-of-loss treaty with Inter-Ocean that would have entailed RenaissanceRe paying Inter-Ocean $21.9 million in premiums over three years. Under the terms of the deal, RenaissanceRe sold or “assigned” $50 million in recoverables that RenaissanceRe had received for just $20 million.

The 10-K is silent on why the two deals were struck, and the company declined to elaborate on the transactions when contacted by Barron’s. Why, for example, would a company take a $20 million loss by selling $50 million in recoverables for just $30 million? Or, in effect, by reinsuring itself on an excess-of-loss policy?

RenaissanceRe was likely on the back end of both deals, so that the bulk of $21.9 million in premiums and $20 million profit on the recoverable deal would flow back to it. A person in a position to know says it seems that RenaissanceRe was trying to establish a cookie jar of future earnings that could be moved from 2001 into later years. In the “hard market” of rising premium rates that followed 9/11, it turned out that RenaissanceRe didn’t need the full income boost. It apparently stopped paying premiums on the excess-of-loss treaty after the first year’s $87.7 million payment. Nonetheless, reparation of the premium flow and recoverable profit in its Inter-Ocean dealings caused RenaissanceRe to understate its reported 2001 and 2003 net income by $20.5 million and $1.3 million, respectively, while overstating its 2002 income by $21.9 million according to “accounting errors” disclosed in the recent 10-K.

The SEC document likewise stated that Independent directors of RenaissanceRe had consisted that senior managers, including CEO James Stennard, a math nerd, had “made mistakes and in some instances lacked due care” in connection with the reinsurance treatment. Made mistakes. Lacked due care. The phrasing implies inattention on the part of company managers. That could be what happened. Or it could be that RenaissanceRe achieved precisely the accounting result that it wanted.

**Inter-Oceans’s 11**
- The companies that own Inter-Ocean, a reinsurer based in Bermuda.
  - Assoc: Electric & Gas insurance
  - American Reinsurance
  - Conventum Holding
  - Chubb
  - GMAC Insurance Holdings
  - Hannover Re
  - Platinum Underwriters Holdings
  - RenaissanceRe Holdings
  - Swiss Reinsurance
  - Westfield Insurance
  - XL Capital

Source: IBRS Weekly