

POSSIBLE COLLATERAL FRAUD IN INSURANCE LINKED SECURITIES

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There is a developing story of a possible fraud involving collateral backed by letters of credit (“LOC”) supporting insurance linked securities (“ILS”) arranged by the Insuretech firm Vesttoo. The Artemis.bm website is covering it (see articles dated July 18 to 20, 2023) and there are few confirmed details but some reports put the amount of collateral with “inconsistencies” in the billions of dollars.

Fronting or ceding companies (they issue the policy to the insured) get protection for some or all of their insurance risks by purchasing reinsurance from one or more other insurance companies called reinsurers. If the reinsurer is licensed or authorized in a U.S. State there is generally no requirement for the reinsurer to post collateral to support the reinsurers’ potential obligations to the ceding company. But if you’re dealing with unauthorized reinsurance (which includes captives and ILS) insurance laws and regulations and good commercial practice require collateral to secure those obligations from the reinsurer. In an ILS transaction, investors purchase bonds with a 3 to 5 year maturity, the bonds fund a special purpose vehicle or offshore reinsurer that enters into a reinsurance agreement with the ceding company to cover the risk, often catastrophe property insurance risks. The ceding company will also pay a premium that tracks the amount that a commercial reinsurer might charge. ILS adds reinsurance capacity alongside the commercial reinsurance market. If losses at the ceding company trigger the ILS reinsurance coverage during the agreement period, a portion or all of the investors’ principal goes to pay the ceding companies’ losses and is lost to the investor. If there is no loss under the reinsurance contract, then the investors get their principal back and earn interest just like any other bond investment. The risk of loss of principal means ILS bond interest is higher than similar corporate bonds and investors also like that fact that price movements in ILS are generally not correlated to other stock or bond markets. Artemis.bm reports that an InsureTech company called Vesttoo appears to have facilitated or arranged an ILS transaction where supporting letters of guarantee or perhaps the collateral may have been forged. It’s reported that the ceding insurer went to a branch of a Chinese bank to draw on the LOC and the bank did not recognize the LOC as valid. Some executives at Vesttoo have departed in the wake of the revelations.

My former company, Reliance, held more than \$1 billion in collateral for captive and other unauthorized reinsurers and for primary casualty large deductibles when it entered liquidation. We never faced fraudulent LOCs in my experience. All ceding insurance companies with large deductible programs or unauthorized reinsurance must have collateral to secure the obligations owed to the insurer. Reliance, like other insurers supporting these products, had robust processes for establishing the amount of the collateral, confirming that LOC wordings were compliant and assessing the security of the issuing bank. State regulations also played a part in some but not all of our

requirements. For instance, NY Regulation 133 (11 NYCRR §79) requires the LOCs for unauthorized to be clean, irrevocable and automatically renewable (“evergreen”), and requires the issuing bank to be U.S. licensed, approved by the National Association of Insurance Commissioners and to meet other limits or qualifications. In addition, our own business standards required a Moody’s or S&P rating at a certain level. Legal requirements for LOCs collateralizing large deductibles are somewhat looser but sound business practice requires that you not be too flexible or you risk holding inadequate or problematic collateral.

In my experience, Reliance never faced a fraudulent letter of credit. However, we did have a top 20 national bank refuse to honor our draw on a \$5,000,000 LOC because the bank had issued their LOC as part of a line of credit. Thus, the bank was completely exposed to loss when our reinsurer and its insurance group collapsed. We filed a Federal lawsuit which convinced the bank of the error of its ways and Reliance was paid in full.

If it turns out that someone has absconded with the investors’ funds or the premium for the transaction paid by the insurer, or both, it creates a new area of compliance and concern for insurers who use collateral to secure these reinsurance and program structures. Unfortunately, wherever there are funds of money, the unscrupulous will spend the time and effort to steal them.

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