See what we can close out

MEMORANDUM

September 9, 2002

TO: M. R. Greenberg
H. I. Smith

FROM: Joseph H. Umansky

RE: Special Re – 2002

The attached shows an $87 million shortfall, $67 million of which relates to Personal Lines which will be repaid over the next 3 years. In addition to points previously raised the following should be noted:

1. SICO replaced Astral on the Union Excess Agreement, which is in the form of a swap.

2. CAPCO will be liquidated by year-end. AIG contracts in CAPCO will be commuted or novated by September 30.

3. Further to our discussion, in planning for 2003, I will be looking to wean us off the Aggregate Stop Loss type treaties. However, I continue to see a demand for discounting contracts in a number of profit centers because of the nature of the business they write. One alternative is to account for these contracts as deposits rather than premiums written. The benefits would be actual expense savings, lower loss ratios, a greater focus on economic gain and the elimination of a backdoor discounting practice. This approach can be used in a limited, defined way. If implemented the change will have a direct impact on GPW but only a minimal impact on NPW. I suggest exploring it further using Environmental policies as a test case.

Joe

[redacted]
Attachments

C C 4/07

RECEIVED IN EXECUTIVE FILES

APR 25 2000

MEMORANDUM

4-20-2000

April 20, 2000

TO: M. R. Greenberg

FROM: Joseph H. Umansky

RE: 2000 Reinsurance Contracts

The contracts summarized in this memo are those to be discussed in a meeting scheduled for Monday.

There are ten contracts listed on the attached schedule and additional information on selected contracts in the attachments. Five of the contracts are similar to the 1999 contracts; I am including them because of the effect that they have on the financial statements. I would like to review six specific contracts with you because of their unique nature. The six contracts are #5 through #10.

All of the contracts are beyond the conceptual stage, but a considerable amount of work needs to be done to put them in final form, including arranging for a reinsurer/counterparty; which could be the most difficult step. I would like to get your reaction to the structures before I proceed. I will cover the six contracts in this memo.

Warranty

Our objective was to convert an underwriting loss into a capital loss. The approach we devised is unique but conceptually, somewhat simple. AIG forms an off-shore reinsurer and reinsures the warranty book into that wholly-owned subsidiary. AIG then sells the subsidiary through a series of partial sales, thus recognizing a capital loss. As the warranty losses emerge they are recognized in this off-shore company that is not consolidated as part of AIG. The accounting is aggressive and there will be a significant amount of structuring required in order to address all the legal, regulatory and tax issues. This is more fully described in Exhibit I.

AIG Catastrophe Cover

The objective was to cap aggregate catastrophe losses for AIG at $75 million. There are a number of issues that we need to discuss, including whether $75 million is the right attachment point and how we define a catastrophe. Since AIG's catastrophe losses consistently aggregate more than $75 million, I am proposing two additional treaties that sit under this catastrophe cover which will mitigate the catastrophe losses and use the discount on the casualty book to subsidize the catastrophe losses.

The two above-mentioned treaties are contracts #9 and #10. They are aggregate treaties (for Foreign Gen and Transatlantic) which have the effect of covering property catastrophe losses with the discount of the related casualty book. These contracts are not specifically catastrophe covers but have the same effect. A similar contract cannot be put together for DBG since this group already has an Aggregate Loss Ratio Treaty (Contract #1). The three contracts are more fully described in Exhibit II. Transatlantic has expressed a number of concerns regarding the treaty.

Personal Lines – Aggregate Loss Ratio Treaty - #5

This is a multi-year excess of loss cover that has the effect of smoothing losses. The attachment is 78%, increasing 1% each year for the term. The premium is constant. Loss recoveries are expected in the first two years. See Exhibit III.

ALICO – Brazil Currency Treaty

This contract is one where a significant recovery is realized and a compensating arrangement through a swap generates a capital loss for ALICO and a gain for the reinsurer. The accounting is very aggressive and it's a duplication of a contract that was done last year. The 1999 swap will not be repeated, although a similar swap will be put in place to accomplish the same objective.

There are a number of other issues that I look forward to discussing with you on Monday.

[redacted]

Att.

cc: H. I. Smith

IG RISK FINANCE
"THE UNCONVENTIONAL SOLUTIONS GROUP"
70 PINE STREET
NEW YORK, NY 10270

DAVID N. FIELDS, ACAS
PRESIDENT

PHONE: 212/770-5814
FACSIMILE: 212/482-6008

9/24/01
11:00 AM

RECEIVED
SEP 2 0 2001

[redacted]

DATE: September 19, 2001

TO: Mr. M.R. Greenberg

FROM: D.N. Fields

RE: Life Settlements – Progress Report

We are poised to commence our life settlements operation. Since we last met on this topic, we have:

- selected Coventry Financial as our life settlements accumulator;
- completed our due diligence review of Coventry, utilizing [redacted] and the MGA review group to ensure the thoroughness of the review. Note that Coventry will not be an MGA.
- designed a structure to maximize the premium and profit that can be recognized. The structure we've created for this purpose will increase the premium booked on a single transaction by over 20 times the amount we originally contemplated. Furthermore, this structure will also enhance our statutory loss ratio and net investment income as well. Generated from the acquisition of 1000 policies (1 Billion in total face amount) is anticipated premium of $700M, loss ratio of 65%, and profit of $100M (in excess of a 6% return); and
- engaged [redacted] and [redacted] who are now producing the documentation we will require for the transaction and will finish the legal due diligence.

We need to alert you that because this market is so small, we deem it likely that people will quickly become aware that we are involved in this field. The public relations risk should be acceptable because the AIG name will not be used in marketing the concept to the life insurance policyholder. [redacted] has stated that Coventry's approach to compliance is exemplary and the regulatory requirement for licensing participants in life settlements reduces our risk further. Furthermore, please note that Financial Service Corporation (FSC - part of Sun America) is currently being paid commissions for developing life settlements business for Coventry – our profile with Coventry will have less public relations risk than exists with FSC.

Per our discussion with Howie Smith, we are also anticipating that AIG funds would be invested via premium financing through AICCO, at least initially. This approach gives

REPORT ON EXAMINATION

OF THE

LEXINGTON INSURANCE COMPANY

AS OF

DECEMBER 31, 1992

State of Delaware

Department of Insurance

Dover, Delaware

I, [redacted] INSURANCE COMMISSIONER OF THE STATE OF DELAWARE, DO HEREBY CERTIFY THAT the attached REPORT ON EXAMINATION, made as of December 31, 1992 of the

LEXINGTON INSURANCE COMPANY

is a true and correct copy of the document filed with this Department.

ATTEST BY: [redacted]

DATE: 3 January 1997

In Witness Whereof, I HAVE HEREUNTO SET MY HAND AND AFFIXED THE OFFICIAL SEAL OF THIS DEPARTMENT AT THE CITY OF DOVER, THIS 3rd DAY OF January 19 97

[redacted]

Insurance Commissioner

Deputy Insurance Commissioner

DOCUMENT CONTROL # 12-03/73/01/93

[redacted]

State of Delaware

Department of Insurance

841 SILVER LAKE BLVD.
P.O. BOX 7007
DOVER, DELAWARE 19903-1507
[redacted]
FACSIMILE [redacted]

REPORT ON EXAMINATION

OF THE

LEXINGTON INSURANCE COMPANY

AS OF

DECEMBER 31, 1992

The above captioned Report was completed by examiners of the Delaware Insurance Department.

Consideration has duly been given to the comments, conclusions, and recommendations of the examiners regarding the status of the Company as reflected in the Report.

This Report is hereby accepted, adopted, and filed as an official record of this Department.

[redacted]

[redacted]

DATED this 3rd day of October, 1996.

44.69% of Transatlantic Holdings, Inc. and its wholly owned subsidiaries, Putnam and Transatlantic. Under Delaware Insurance Code Section 5002 (5), Control is defined as:

> "Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote or holds proxies representing 10% or more of the voting securities of any other person. This presumption may be rebutted by a showing made in the manner provided by Section 5004 of this title that control does not exist in fact...."

There is a presumption under Delaware law that Putnam and Transatlantic are controlled by AIG based on ownership. The Company has not filed a rebuttal to the presumption of control. It is recommended that Putnam Reinsurance Company and Transatlantic Reinsurance Company, be classified as affiliates in any statutory filings made by the Company. A similar recommendation was made in the 1988 Report of Examination.

Coral Reinsurance Company Ltd. (Coral Re)

The Company reported $119 million ceded to Coral Re in the December 31, 1992 Annual Statement. Coral Re was formed on December 14, 1987 under the laws of Barbados. At December 31, 1992, Coral Re was owned by shareholders from France and Canada.

In 1995, documents were obtained through a Freedom of Information Act request from the Arkansas Development and Finance Authority, one of the initial shareholders of Coral Re, which included the "Confidential Private Placement Memorandum" (Private Placement) provided to potential investors. According to the Private Placement, Coral Re was "...designed to reinsure certain risks from several of the U.S. subsidiary insurance companies of American International Group, Inc. (AIG). AIG's interest in creating the Company [Coral Re] is to create a reinsurance facility which will permit its U.S. companies to write more U.S. premiums. For a

U.S.-domiciled company, a high level of surplus is required to support insurance premiums in accordance with U.S. statutory requirements. The statutory requirements in Barbados are less restrictive." Coral Re was not created to write reinsurance in the general market place or to provide reinsurance for companies outside the AIG Group. It appears that virtually all of Coral Re's business originates from the companies in the AIG Group. Although AIG does not have a stock ownership interest in Coral Re, it played a significant role in its creation, including the design of the reinsurance contracts.

The Department has questioned whether AIG controls Coral Re. The Department's concerns were based on the definitions of "Affiliate" and "Control" contained in Delaware Insurance Code, Chapter 50, "Insurance Holding Company System Registration", "Section 5001. Definitions". The definitions are as follows:

> ""Affiliate." An "affiliate" of, or person "affiliated" with, a specific person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified."
>
> ""Control." The term "control" (including the terms "controlling", "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or non-management services, or otherwise, unless the power is the result of an official position with or corporate office held by the person. Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing, ten percent or more of the voting securities of any other person. This presumption may be rebutted by a showing made in the manner provided by Section 5004(k) of this title that control does not exist in fact. The Commissioner may determine, after furnishing all persons in interest notice and opportunity to be heard and making specific findings of fact to support such determination, that control exists in fact, notwithstanding the absence of a presumption to that effect."

The Department has questioned whether Coral Re may be an affiliate based on control in accordance with the above definitions. Control under this definition may be demonstrated by the following:

- AIG played an integral role in the creation and design of Coral Re, including the terms of the reinsurance prior to any involvement by the investors.

- The Private Placement states that "*AIG's interest in creating* [emphasis added] the Company [Coral Re] is to create a reinsurance facility which will permit its U.S. companies to write more U.S. premiums." In addition, the reinsurance treaties that were to be entered into with Coral Re were attached as exhibits to the Private Placement. Thus the basic terms of the reinsurance were determined by the creators of Coral Re prior to any solicitation of investors. AIG was actively involved in the process of obtaining investors to purchase stock in Coral Re.

  The Private Placement states that "AIG and the Company [Coral Re] will make available to any prospective qualified investor, prior to the closing date for the sale of the common stock, the opportunity to ask questions of and to receive answers from AIG and/or the Company [Coral Re] concerning the terms and conditions of the offering, the Company [Coral Re] or any other relevant matters, and to obtain any additional information to the extent that AIG or the Company [Coral Re] possesses such information or can acquire it without unreasonable effort or expense."

- The purpose for creating Coral Re was to reinsure risks for the AIG group of insurance companies. It was not created to reinsure any other company or write reinsurance in the general marketplace.

  The Executive Summary Section of the Private Placement states "The Company [Coral Re] is designed to reinsure certain risks from several of the reinsurance subsidiaries of American International Group ("AIG")." The Company Summary, which is Section II in the Private Placement, under "Purpose:" states "Provide reinsurance for certain AIG subsidiaries." Coral Re was incorporated on December 14, 1987, and began writing AIG business on December 18, 1987. A similar contract with Putnam Reinsurance Company, an AIG affiliate, was terminated on December 16, 1987. Virtually all of Coral Re's business has continued to originate from AIG through December 31, 1992.

- Coral Re is managed by a member of the AIG Group.

  Coral Re entered into a management agreement dated December, 1987 with American International Management Company Limited (AIMCO), an AIG company, domiciled in Barbados. The agreement states that AIMCO agrees "to do all things necessary or incidental to the conduct of the insurance or reinsurance business which the Company

[Coral Re] now is or hereby may be by its charter authorized to transact; and to maintain books and records with respect to the business hereunder and render annual accounts and other schedules in such form and detail as the Company [Coral Re] may reasonably require." This statement is far more encompassing than the "back office accounting" function which is how AIG officials have described AIMCO's role.

- The economic viability and health of Coral Re is dependent on the reinsurance ceded to it by the AIG companies.

As of December 31, 1992, most of Coral Re's assets were derived from reserves ceded to it by the AIG companies and the related investment income earned on those assets. Most of Coral Re's assets were pledged for letters of credit collateralizing reserves assumed from companies in the AIG Group. In addition, the AIG companies continue to be virtually the only source of business for Coral Re.

- The return, to the owners of the common stock, is based on their investment in Coral Re, not on its overall profitability.

Under their investment agreement, the equity owners of Coral Re do not expect to receive any other profits and will not receive less than the investment return discussed in the Private Placement. The mechanism for accomplishing this is contained within the original Private Placement and does not require the active involvement of Coral Re. As a result, the investors in Coral Re have little or no interest in controlling and actively managing the reinsurance aspect of Coral Re's arrangements with AIG.

According to the Financial Review Section of the Private Placement "An Investor in the Company [Coral Re] is expected to earn a pre-tax return on its investment equal to the sum of its share of the investment returns on the total equity capital plus 2% per annum." The 2% per annum is the risk fee paid to the equity owners for investing in Coral Re.

- Investment in Coral Re is structured so that its book value is maintained at an amount that is at least equal to the value of the equity owners' original investment.

An investor that wants to terminate his investment under the exit provision is entitled to receive book value for his investment. Due to the previously mentioned mechanism, an investor terminating his investment will basically be receiving a return of cash approximately equal to the amount he originally invested plus investment income and the risk fee less financing expenses. The mechanism for accomplishing this is contained within the original Private Placement and does not require the active involvement of Coral Re.

As a result of the above, the Department has expressed concerns that Coral Re may be "under common control with" the AIG group of companies because AIG may have "...possession of, direct or indirect, power to direct or cause the direction of the management and policies of..." Coral Re. In order to alleviate the Department's concerns regarding the close relationship of the AIG companies to Coral Re, the Company has agreed to stop ceding any business to Coral Re and commute $100 million of the reinsurance credits currently being taken. The Company has also agreed to report any reinsurer that has the previously mentioned characteristics as an affiliated reinsurer in future filings with the state insurance regulators.

The Company has provided the Department with a copy of an opinion letter prepared by the New York law firm of [redacted] This letter was prepared at the request of American International Group, Inc. ("AIG") to respond to questions raised by the New York Insurance Department in connection with the examination of certain New York domiciled subsidiaries of AIG. This law firm opined that the Company does not control Coral Re within the meaning of the New York Insurance law. This opinion was reviewed by the Department as part of the examination.

Parental LOC

Beginning in 1985, the Company began utilizing a "Parental Blanket Letter of Credit" (AIG LOC) to reduce the Provision for Unauthorized Reinsurance for various reinsurers who have not otherwise provided collateral for reinsurance ceded. The AIG LOC originally approved by the Department was for $20,000,000. No requests for increases in the original amount approved have ever been received by the Department. The amount of the AIG LOC has increased in recent years as follows:

1985	$25,000,000	1990	$ 85,000,000
1986	35,000,000	1991	100,000,000
1987	35,000,000	1992	120,000,000
1988	50,000,000	1993	120,000,000
1989	65,000,000	1994	200,000,000

As of December 31, 1992, the AIG LOC had increased to $120,000,000, $100,000,000 more than the amount originally approved. A further discussion of the AIG LOC can be found in this Examination Report under the "Provision for Unauthorized Reinsurance" caption.

It was noted that although reinsurers covered by this AIG LOC have failed over this time period, the AIG LOC has never been drawn upon. Instead these unrecoverable balances have been transferred to Coral Re.

The Company has represented to the Department that the purpose and function of the AIG LOC is to protect it when unauthorized reinsurers become insolvent. The Department has stipulated that the provision for unauthorized reinsurance may not be reduced using the AIG LOC unless the Company draws on it when a covered reinsurer does not pay in accordance with the underlying reinsurance agreement.

It is recommended that the Company draw upon the AIG LOC as soon as the reinsurers covered by it go into default in accordance with the intention of that LOC. In addition, recoverable balances which have been secured by the AIG LOC should not be transferred to the Coral Re agreement, or any similar agreement.

Reinsurance Ceded - Coral Reinsurance Company

General Information

The Company and its affiliates in the American Home/National Union pool and Landmark Insurance Company, collectively referred to as the Domestic Brokerage Group, are participants in several "Reinsurance Agreements" with Coral Re.

Due to the significant impact this one reinsurer could have on the financial stability of the Company, the agreements with Coral Re were reviewed very carefully.

The following three contracts, as referred to by the Company, were in place between the Company and Coral Re as of December 31, 1992:

- Reinsurance Agreement
- Aggregate Loss Ratio and Excess Agreement
- Quota Share Replacement Agreement

Due to the unusual nature of these agreements, they were submitted for review to the NAIC's Senior Reinsurance Manager. His conclusions were in agreement with the following discussion of the treaties.

The Department met with the Company's external auditors [redacted] and obtained copies of their audit work papers and various memorandums concerning their evaluation and assessment of the company's relationship and transactions with Coral Re. The Department's discussion with [redacted] and review of their documentation covered [redacted] work dating back to 1987. [redacted] work papers document that [redacted] has accepted the company's position that the reinsurance agreements with Coral Re transfer underwriting risk. [redacted] opinion was reviewed by the Department as part of this examination.

Reinsurance Agreement

This agreement, dated December 18, 1987, provides 100% reinsurance on up to $2.5 million for any one risk or insured not to exceed the Company's matching net retention on certain lines of business. The agreement covers business written by the Company on May 1, 1987 and subsequent. Premiums are allocated based on policy limits and 87.5% of the original premium is paid to Coral Re.

A Reserve Deposit clause for non-admitted reinsurers requires that Coral Re's share of losses, IBNR and loss adjustment expense reserves be secured. Coral Re provided the Company with a letter of credit to satisfy this clause as of December 31, 1992.

Aggregate Loss Ratio and Excess Agreement

This agreement, dated January 1, 1992, contains two sections and is effective until all liabilities of the Company are settled. "Section A" relates to combination risk excess coverage and "Section B" relates to loss ratio coverage. The premium for both sections, collectively, according to the agreement, is a flat amount of $8,000,000 with no adjustment provisions.

"Section A" covers all losses occurring during the 1992 accident year in excess of the Company's retention. "Section A" coverage affords $5 million excess coverage but not more than $10 million per occurrence, and is subject to a maximum of $35 million for the term of the agreement. "Section B" provides for aggregate protection in excess of a 70% loss ratio for 1992 accident year losses.

The Net Retained Lines clause of the agreement excludes unrecoverable amounts from any other reinsurer. Therefore, this coverage does not overlap the Quota Share Replacement

Agreement discussed in detail below. Losses prior to January 1, 1986 are also not covered under this agreement. The agreement does not contain a cancellation clause nor a commutation provision of any kind.

The Delaware Insurance Department was provided a copy of Coral Re's audited financial statements. The audit opinion was unqualified, however it was noted that as of December 31, 1992 Coral reported total liabilities of $930,132,177, including outstanding losses of $884,728,120, and total shareholders equity of $15,049,289. The ratio of outstanding losses to equity is 59: 1 and the ratio of total liabilities to equity is 62:1.

The notes to the audited financial statements indicated that the loss reserves "...were reviewed by an independent consulting actuary...". Due to the high ratio of outstanding losses and total liabilities to equity, the Department requested a copy of the existing actuarial opinion on the Coral Re reserves. Although a Company official confirmed that an actuarial opinion was in existence, he said that he had requested a copy from Coral Re who indicated that they must obtain approval from their Board of Directors before releasing the report. The Company later stated that they were unable to provide the actuarial report because the Board of Directors of Coral Re voted not to release it to the Delaware Insurance Department.

A Reserve Deposit clause for non-admitted reinsurers requires that the reinsurer's share of losses, IBNR and loss adjustment expense reserves be secured. Coral Re provided the Company a letter of credit to satisfy this clause as of December 31, 1992.

Quota Share Replacement Agreement

This agreement is the most significant of the Company's agreements with Coral Re. The inception date of this agreement was December 18, 1987, four days after Coral Re was incorporated. This agreement replaced a similar agreement with Putnam Reinsurance Company, an AIG affiliate, which was terminated on December 16, 1987. The agreement provides that the Company be reimbursed for uncollectible reinsurance (Section A) and adverse development on commuted treaties (Section B).

No demonstrable risk transfer appears to exist in exchange for the risk fee described in the quota share agreement. The retrospective rated risk fee component of the treaty premium is calculated as follows for all years since inception:

- Flat risk fee of $700,000 annually
- Plus 1% of the minimum premium as stated in the agreement
- Plus all applicable operating expenses (including the cost of lines of credit used to secure the Company's unauthorized recoverables from Coral Re)
- All subject to a minimum risk fee of $1,790,200 for each year the contract is in effect.

The remaining components of the treaty premium are calculated as follows:

- Plus cumulative paid losses
- Plus outstanding losses
- Plus any return premium paid
- Less the yield on investable funds, where investable funds are the net premium paid to Coral Re less the risk fee and applicable expenses. The Department requested details of the calculations. The Company responded that they were not in possession of the details which support the investment yield calculation. They also informed the Department that the Pennsylvania Insurance Department made the request directly of Coral Re and Coral Re refused to provide the details.
- Plus prior cumulative yields
- Less losses (net of recoveries) paid to the Company.

The agreement requires a provisional premium for Section A of 200% of the minimum premium stated in the agreement. The minimum premium is not determined until the last quarter of the contract year. Subsequent endorsements are made in accordance with the retrospective risk fee rating provisions of the contract outlined above.

The contract language indicates that each contract period (January 1st to December 31st) would be reviewed independently, that is, replaced reinsurers (Section A) or commuted treaties (Section B) would be associated with the contract period in which they were initially ceded (declared) to this treaty. If the experience for the transferred reinsurers developed such that the losses exceeded the policy year limit, the excess would not be covered by the agreement.

The Company has represented that the parties to the contract view the agreement as an aggregate of experience from the inception of the contract. Under such a view the Company would expect that any excess in a given period would be covered by the unused limits of other treaty periods. This "view" of the parties, according to the Company, is not explained in the contract wording.

Section A

Agreement provisions for Section A allow the Company to transfer to Coral Re all "loss and premium liability" that has been previously ceded to a reinsurer whereby the Company has or would incur a loss because of the inability of the reinsurer to pay amounts due or to become due by reason of "Financial Impairment" or "Government Regulation". Under the contract provisions the Company shall solely decide if "Financial Impairment" exists.

Chapter 22, Reinsurance, of the "Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies" (Chapter 22) published by the NAIC stipulates the following under "Reinsurance Contracts Include Transfer of Risk":

> "The essential ingredient of a reinsurance contract is the shifting of risk. A subcommittee of the National Association of Insurance Commissioners which studied alleged problems in certain reinsurance agreements reported:
>
> > The essential element of every true reinsurance contract is the undertaking by the reinsurer to indemnify the ceding insurer [i.e. reinsured company], not only in form but in fact, against loss or liability by reason of the original insurance. Unless the so-called reinsurance contract contains this essential element of risk transfer, no credit whatsoever shall be allowed on account thereof in any accounting or financial statement of the ceding insurer.
>
> Insurance risk involves uncertainties as to the ultimate amount of any claim payments (underwriting risk) and the timing of those payments (timing risk). An insurance contract indemnifies the insured against loss from such risks. Risk must be fortuitous; that is, the possibility of adverse events occurring must be outside the control of the insured.
>
> In addition to insurance risk, reinsurance contracts involve other business risks including, but not limited to, investment yield risk, credit risk and expense:...
>
> - Credit risk relates to the exposure that the amounts due or to become due under the contracts may not be fully collectible. Such amounts include those currently due for reinsurance recoverable on paid losses as well as amounts that will become due for reinsurance recoverable on unpaid losses and amounts receivable under contingent commission or profit-sharing arrangements...."

It is the Department's opinion that the coverage provided under this section of the agreement only transfers "credit risk" as defined in the above section of Chapter 22 because it only covers a loss resulting from the inability of the reinsurer to pay amounts due or to become due. It follows from this opinion that neither the underwriting nor the timing components of "insurance risk" as defined in Chapter 22 are transferred. Chapter 22 requires that:

"Reinsurance contracts that do not transfer both components of insurance risk shall be accounted for and reported as deposits in the NAIC annual and interim financial statements..."

The Company has agreed to run-off the quota share and other Coral Re treaties under the transition rule. It is recommended that the Company account for cessions that do not meet the test of insurance risk transfer and have not been stipulated as being run-off under the transition rule as "deposits" in accordance with Chapter 22 of the NAIC's Accounting Practices and Procedures Manual.

Section B

Section B consideration is equal to the cost established by the Company for any commutation agreements transferred to Coral Re in accordance with Section B of the agreement. The consideration paid to Coral Re equals the cash received from the commuted treaties less the portion of the cash attributable to the paid portion of the loss. It is important to note that the Company does not record this cash as a new transaction, but instead changes the billing information to reflect Coral Re via a memo entry. The name of the original reinsurer remains in the Company's reinsurance accounting system with Coral Re designated as the responsible party under the Coral Re agreement. This method of recording the transfer allows the Company to avoid recording any loss for the difference between the cash received from the commutation and the related liabilities.

The commutation of a reinsurance contract and the transfer made under Section B are two distinct events and need to be recorded separately. It is recommended that the Company record a charge to the income statement for the difference between the assets received and the ultimate value of the commuted losses or claims on all commutations. The Company has agreed to run-off the quota share and other Coral Re treaties under the transition rule. It is recommended that the Company account for cessions that meet the definition of "loss portfolio transfers" and have not been stipulated by the Company as being run-off under the transition rule as "loss portfolio transfers" in accordance with Chapter 22 of the NAIC's Accounting Practices and Procedures Manual. The basis for the recommendation for loss portfolio transfer accounting is discussed below.

Chapter 22 stipulates the following under "<u>Loss Portfolio Transactions</u>":

> "Certain arrangements, often characterized as reinsurance agreements, are structured to apply retroactively to a portfolio of losses which occurred prior to the effective date of the agreement. Due to potential abuses involving the creation of surplus to policyholders, and which will result in the distortion of underwriting results, a special accounting treatment for such agreements is warranted.
>
> As used in this manual, "loss portfolio transfer" means an agreement in which:
>
> 1. The transferer's (ceding insurer's) surplus to policyholders increases as a result of payment of consideration to a transferee (assuming insurer) for undertaking any loss obligation already incurred; and
>
> 2. The consideration paid by the transferer, in connection with transferring such loss obligation, is derived from present value or discounting concepts based upon anticipated investment income."

In general, loss portfolio accounting will be necessary when the consideration and the losses are transferred to another party because criteria 1 and 2 above are met. As a general rule, when a reinsurance contract is commuted, the Company accepts the present value (or another amount which is less than full value), for reinsurance recoverable on claims to be paid at full value over a future period. If the ceding company transfers the assets received and the related existing losses to another reinsurer the transaction meets the criteria previously discussed for a loss portfolio transfer. It meets the first criteria because the assets received are less than the loss reserves transferred, which results in an increase to policyholders' surplus. It meets the second criteria because the reinsurer is dependent on anticipated investment income in order to generate adequate cash to pay the ultimate losses.

The Department has determined that the quota share reinsurance agreement between the Company and Coral Re does not transfer underwriting risk in accordance with Chapter 22. It was not possible for the Department to quantify the adjustment which would be required because the accuracy of the supporting documentation provided by the Company could not be verified. However, the Company has agreed to run-off all of the Coral Re treaties, including the quota share treaty and any similar treaties under the transition rule contained in Chapter 22 and place no new business with Coral Re after December 31, 1995. In order to utilize this rule, the Company has agreed to do the following with the Coral Re treaties, any similar treaties with other companies and any other treaties that do not comply with Chapter 22:

- Provide the Department with a list of reinsurance treaties that will be run-off under the transition rule.
- Stop ceding premium to Coral Re and other companies having reinsurance treaties that will be run-off under the transition rule.
- Run-off the existing reinsurance treaties with Coral Re and other reinsurance treaties listed as being run-off under the transition rule.
- Commute $100 million of liabilities with Coral Re.
- Make certain that all existing reinsurance agreements not being run-off under the transition rule comply with Chapter 22.

Make certain that all future reinsurance agreements comply with Chapter 22.

The Company has contended that several items requested in connection with the examination are not available and are under the proprietary control of a third party (Coral Re). The quantity and quality of information purportedly available at the Company regarding Coral Re is severely lacking, considering the fact that it is one of the Company's major reinsurers, even though it is the Company's contention that Coral Re is a completely independent third party.

The Company was requested to provide supporting documentation for cash transactions in the form of processed drafts, wire transfers and bank deposits. Instead, entry memos to the AIG Intercompany Pool were provided. The memos could not be traced to cash amounts reported by the Company. The Company has not provided the evidence requested. This is a violation of Delaware Insurance Code Section 324(c) as follows:

> "Every person being examined, its officers, attorneys, employees, agents and representatives shall make freely available to the Commissioner or his examiners the accounts, records, documents, files, information, assets and matters of such person in his possession or control relating to the subject of the examination and shall facilitate the examination."

Due to the numerous violations of Section 324(c), subsequent references to this section in this examination report will be, "This is in violation of Section 324(c)".

It is recommended that the Company prepare and maintain detailed documentation on all cessions made to Coral Re. This would include detailed documentation on all commutations.

SHORT CERTIFICATE

STATE OF NEW YORK

INSURANCE DEPARTMENT

It is hereby certified that the annexed copy of Report on Examination of AMERICAN HOME ASSURANCE COMPANY, of New York, New York, dated July 6, 1995, showing condition as of December 31, 1991,

has been compared with the original on file in this Department and that it is a correct transcript therefrom and of the whole of said original. The correspondence attached at the beginning of this report is not included in the original on file.

In Witness Whereof, I have hereunto set my hand and affixed the official seal of this Department at the City of Albany, this 9th day of February, 1998.

[redacted]

REPORT ON EXAMINATION

OF THE

AMERICAN HOME ASSURANCE COMPANY

AS OF

DECEMBER 31, 1991

DATE OF REPORT JULY 6, 1995

EXAMINER [redacted]