Case Study on Corporate Governance

What went wrong and who were to blame?

Introduction

The **Guarantee Life Insurance Company** (**GL**) was one of the largest life insurers in its country. It had around 56 thousand policyholders when it went bankrupt and the liabilities amounted to 620 million, the assets being worth only 230 million. The deficit thus amounted to 390 million or 63 % of the liabilities

Questions: *How could the insurance company end up with such a deficit and who were to blame for this happening? Please examine the owners, senior management, auditors and supervisors/regulators, and explain what they did wrong. Please indicate what you think they should have done differently and at what stage. Please note that the answers do not necessarily need to be directly related to corporate governance.*

Background

Mark Sanford, who was known as a hard working man with good investment skills, and William Blackburn, a sociable marketing man, worked as brokers for a small securities firm when they decided to set up a holding company named **Transmark**. Initially this company was a brokerage firm but it later moved into mutual funds. Through this holding company they later bought GL, which was a small and modestly profitable life insurance company with assets of almost 100 million. The purchase price was 7 million and the purchase was to 80 % funded by a bank loan. Neither Sanford nor Blackburn had any insurance experience but presented themselves as having other valuable knowledge. Thinking that the assets of the company were underperforming, their idea was that by using Sanford's investment expertise, the company would make a higher return on its investable assets.

Some of the staff that worked in the life insurance company at the time of the purchase, including the CEO, were dismissed and replaced as Sanford and Blackburn found them uncooperative. Instead Blackburn became the CEO and Sanford took up the position as Chairman of the Board. Sanford's wife and brother also took up important positions in GL. The woman who was appointed Head of Marketing later married Blackburn.

Aiming for growth

In order to exercise their investment skills, Sanford and Blackburn needed a bigger capital base. They took steps to increase GL's assets by adopting a marketing strategy, which involved selling single-premium annuities and single-premium life policies. These typically provide large up-front payments to the insurer, thus maximising the amount of assets available for investment.

The marketing strategy consisted of paying good interest rates to policyholders and high commissions to their agents. As the commissions were higher than what other companies offered, the number of agents selling GL products increased considerably over the next few years. GL targeted low-income, unsophisticated investors and most of the annuity policies were for relatively small amounts. The policies, which offered above-average interest rates, were guaranteed for an initial period of one year. The agents may have given the clients the impression that the high rates were likely to continue indefinitely due to the extraordinary investment skills of Sanford but the interest rates dropped sharply over the next few years. Most of the products had fairly high surrender penalties, which meant that although some customer might have wanted to leave the company, they felt they could not afford to do so.

In three years GL became very successful in increasing its assets – from around 100 million they grew to more than 500 million. GL marketed itself as being more successful than other, bigger and more established companies, showing their rapid growth as a sign of success.

Investment strategy and regulatory reforms

To pay above-average rates, the company needed to make above-average returns and they did that by investing 90 % of its assets in high yield bonds, so called *junk bonds*. The idea was to have a diversified portfolio of junk bonds, of which some would undoubtedly default, their losses, however, being offset by high returns on the other bonds, thus providing an attractive return overall.

Some of the junk bonds of GL were also bought as part of special deals. Some favoured investors, such as GL, were given the opportunity to buy certain high value securities at low price if at the same time buying certain junk bonds. These unlisted securities provided an opportunity to make large profits at very little risk. The junk bonds were bought and kept by GL, while the associated securities were stripped off and kept by Sanford and Blackburn.

There was an increasing concern about the junk bond market since a couple of defaults had been triggered by large holdings of such bonds. The government therefore decided to pass a law that would force insurance companies to reduce their holdings to a maximum of 20 % of junk bonds. GL, which was well above the threshold, persuaded the regulator to introduce a *grandfathering* provision, allowing the company to reduce its holdings over a longer time period.

Forced sales of junk bonds had the effect of pushing down their prices and the whole market eventually collapsed. GL, which still had significant holdings, ended up suffering severe losses on its junk bond portfolio. To remedy the problem the company decided to cut the bonus rates paid to policyholders. This lead to a wave of surrenders, which resulted in payouts of 30 million per month. In order to make those payments, GL sold off its better quality, liquid assets, resulting in remaining assets of poor quality or in default.

Shortage of capital, creative solutions and accounting practices

GL went insolvent and the supervisor proceeded to wind down the company, putting it into administration in order to run-off the company in an orderly manner. As part of this process, forensic accountants were brought in to determine the true financial position of the company. It was discovered that GL had been technically insolvent for years, although the financial statements had not shown any financial problems during this time. The following explained some of the problems and why they had not been apparent in the accounts.

Life companies were required to set aside technical provisions, which should be calculated according to specified assumptions defined by the regulator. These assumptions were conservative in order to ensure a high probability of future claims being paid. As GL was charging low premiums and paid high commissions, the cash inflow was insufficient to provide the required reserves for new business. This meant that the more policies they sold, the worse the problem became.

In order to solve this problem, the company adopted an approach involving the use of *finite reinsurance* and *end-of-year swap transactions*.

The finite reinsurance contract was structured so that the liabilities were initially passed on to the reinsurer, with a clause ensuring that some or all of the losses were passed back to GL. Rather than being a genuine risk transfer, the transaction was in reality a loan. Having it reported as a risk transfer, however, improved the solvency level in the accounts. There was a large number of finite reinsurance transactions and most of the contracts were organised shortly before the end of the financial year.

The supervisor had a risk-based regulatory system where assets were graded according to their risk of default, higher risk resulting in higher capital requirements. Junk bonds were in the highest risk category and GL had many of them. As the calculation of the risk charges were made at the end of the year, GL decided to sell their junk bonds to investment bankers at this time, buying them back for approximately the same amount at the beginning of the following year. In the meantime GL held cash or receivables from brokers, which were considered safe, giving no risk charge at all.

The accounting regime was public financial accounting according to the local GAAP and statutory accounting for supervisory purposes. While GAAP would require the accounts to *show the true financial impact of any transaction*, the statutory accounts were to be established according to predefined technical rules, the aim being to build in some prudence and conservatism in the calculations. Under GAAP the correct treatment of the Swap transactions would show GL as being the owner of them also at the year-end and this was also the opinion expressed by the auditor, which resulted in Sanford firing him. He decided to rehire the firm a few months later, this time to do the statutory accounts and the audit firm now agreed to treat the swaps as a genuine transaction.

Financial benefits and recovery

Although GL was on the verge of insolvency for several years, Sanford and Blackburn managed to make personal profits during this time. They executed self-dealing management agreements and paid themselves fees as investment advisors to the insurance company. GL also paid dividends to Transmark during this time and the supervisor did not object as the statutory returns showed a surplus.

Blackburn left GL two years before the collapse and bought a small insurance subsidiary from GL. The company had never sold any policies, and never did, but it had a source of funds consisting of a reinsurance premium paid by GL, which was used for investments. At the time of GL's bankruptcy, most of this money had been lost in various investment transactions.

The administrator of GL attempted to recover some money from Sanford and Blackburn, and their associates. Unfortunately many of these assets were held off-shore, making it difficult to obtain restitution. Luckily there was a state guarantee fund to protect the policyholders from losses and the money was raised by imposing levies on other insurers. The policyholders that had not been transferred to other insurers could thus be paid in total.