



Someone Else's Problem: A Case Study in Regulatory Failure

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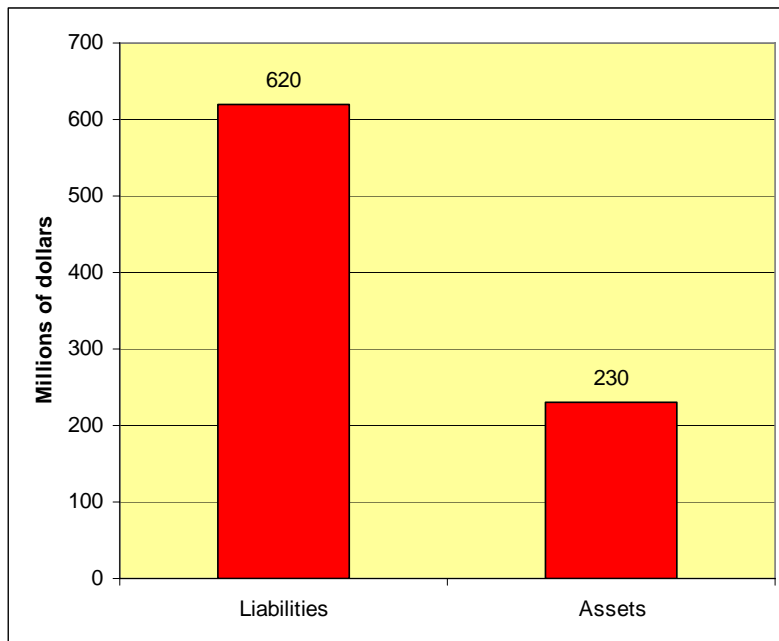
A Failure of Regulation

Not all insolvencies represent a failure of regulation -

In a competitive system, some insurers will fail. The aim is to protect the policyholders from serious losses.

On this criterion, GSL is a spectacular example of regulatory failure.

Guarantee Security Life (GSL)



- Florida Life Insurer
- 56,000 policyholders
- Mostly low/middle income, retirees
- Receivership in 1991
- Assets =
37% of Liabilities
Possibly the most
inappropriately named
insurer in history ?



Other People's Money

- There will always be people who want to gamble with other people's money – using insurance companies.
 - ? Australian examples ?
- So we have a prudential system with processes and watchdogs – legislators, regulators, accounting standards, auditors, actuaries, rating agencies, legal systems, etc etc.
- So how well did it work out at GSL?



Evidence to the Inquiry

‘Guarantee Security was almost from the beginning a massive fraud, aided and abetted by blue-ribbon brokers and licensed professionals motivated by their own self interest. The fraud of Guarantee was a carefully-orchestrated bank robbery, but the thieves disguised themselves with the help of accountants, brokers and lawyers rather than wearing silk-stocking masks. They operated like early 20th century robber barons, cloaking their thievery in the guise of a sound business organisation.

We regulators were deceived....’

Testimony to the United States Senate Permanent Subcommittee on Investigations, by Florida Treasurer and Insurance Commissioner Tom Gallagher, April 29, 1992



Outline

- 1. The Owners
- 2. The Marketing Plan
- 3. Dealing with New Business Strain
- 4. Investment Policy
- 5. Managing the Capital Requirements
- 6. Investments in Affiliates
- 7. The Aftermath



The Owners : Sanford and Blackburn

- Mark Sanford : the investment genius (?)
- William Blackburn: the gregarious marketing guy
- Worked as brokers (successful ?)
- Set up Transmark
- Transmark bought GSL, a “small modestly profitable insurer” with assets of about \$100 million
- Paid about \$7 million on a “very leveraged basis”



Q1. If you were the regulator, would you allow these two to buy an insurance company ?

- Pros

- Willing seller
- Experienced team
- Nothing known against them

- Cons

- No experience
- Business Plan ?
- 100% control (not an issue in Florida)



Experience

- Senator: Mr Blackburn, prior to your purchase of GSL, did you have any training or experience in the insurance industry?
- Mr Blackburn: No sir.
- Senator: You did not?
- Mr Blackburn: I did not.
- Senator: But you were running one.
- Mr Blackburn: I was running one.
- Senator: Did that give you any concern or worry ?
- Mr Blackburn: Yes sir it sure did.
- Senator: What did you do about it ?
- Mr Blackburn: I moved to Florida and jumped in with both feet and did everything I could to learn about the insurance business as fast as I possibly could.



New Management Team

- Soon after the takeover, Sanford and Blackburn sacked existing GSL management (*“totally uncooperative”*)
 - Blackburn – CEO
 - Sanford - Investment Manager and Chairman
 - Sanford’s brother - CFO
 - Blackburn’s soon-to-be wife – Marketing
 - Sanford’s wife – Board of Directors (Transmark)



Regulatory Approval

- How could people like Sanford and Blackburn obtain a license from the regulator?
 - *“Inexperienced people were able to obtain a state license to sell insurance because there was no known reason to deny them.” (Gallagher)*
- Over the period 1979 to 1987, 130 new insurance companies entered the Florida market. [*“Gunter tells Task Force Florida Regulation is Working, Insurance industry is flourishing in Florida”*]
 - *“As long as they put up the money to capitalize the company, and are not convicted felons, we'll give them a certificate of authority,” says one Insurance Department staff member in Tallahassee.*
 - *The staffer, who asked not to be identified, says “you can tell from their applicants' business plans that they have no idea what they're getting into.”*



"It's Utter Nonsense"

- *“Just a few months after Insurance Commissioner Bill Gunter gave Carlos and Jose Pina a license to run an insurance company, the Pinas sat down with him and gave him a token of their appreciation.*
- *The token, Carlos Pina says, was \$10,000 in campaign contributions.*
- *Carlos Pina, in a previously undisclosed statement to federal investigators in 1986, said he gave the money as his part of a deal to speed approval of the license for his Universal Casualty Insurance Co.*
- *Gunter, who is now running for U.S. Senate, acknowledged receiving the 1982 contributions. But he said the money did not affect his regulation of the company, and he said he did nothing wrong or illegal”* (St Petersburg Times, 6/8/88)



Corporate Objectives

- *I didn't really want to be in the insurance business. There were essentially two reasons for doing it. The first and foremost reason was that Mark Sanford and I for some years had been in the money management business. We were seeking new money to manage.*
- *We took notice that insurance companies had what we considered to be relatively low-quality management of their assets, underperforming assets, and we thought that if we could buy an insurance company two things would happen.*
- *One is we could gain the management of the assets of the insurance company, thereby gaining a client, and two is that we thought we could value-add to that company by making a higher rate of return on its investable assets”.*



Marketing

- Objective: Obtain as much money as possible as quickly as possible, to invest in assets which would provide a high return.
 - Q. *How would you do this?*



GSL's Marketing Plan - Retail

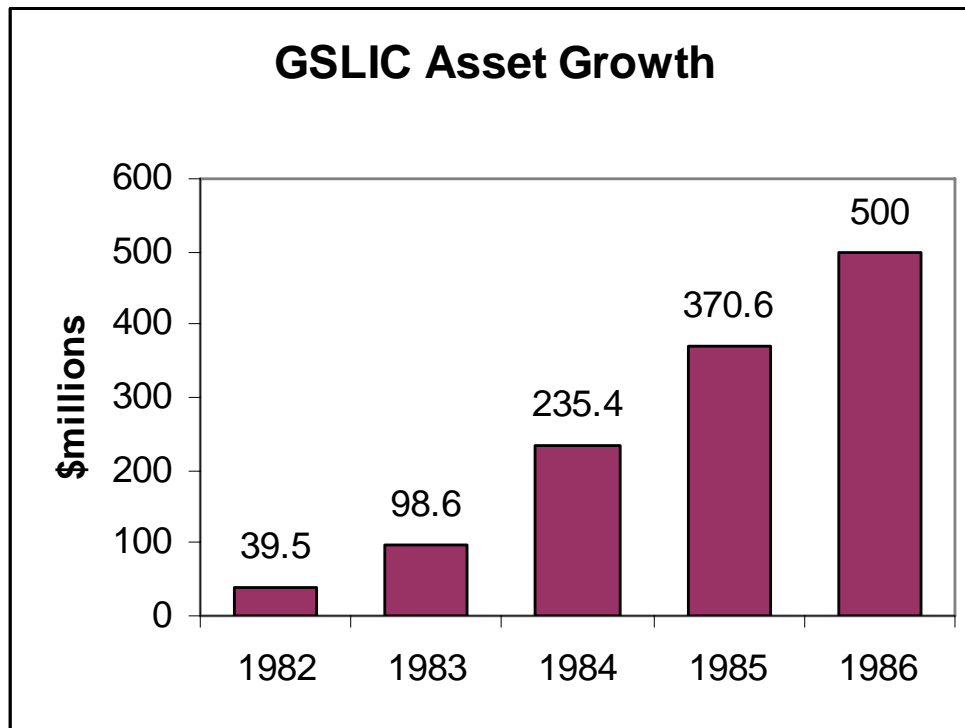
- Single premium annuities (large cash inflow)
- Guaranteed high interest rates (1 year?)
- Lowest price in the market
- Excellent commission rates
- Rapidly increasing sales force
- Large Surrender Penalties (lock in)



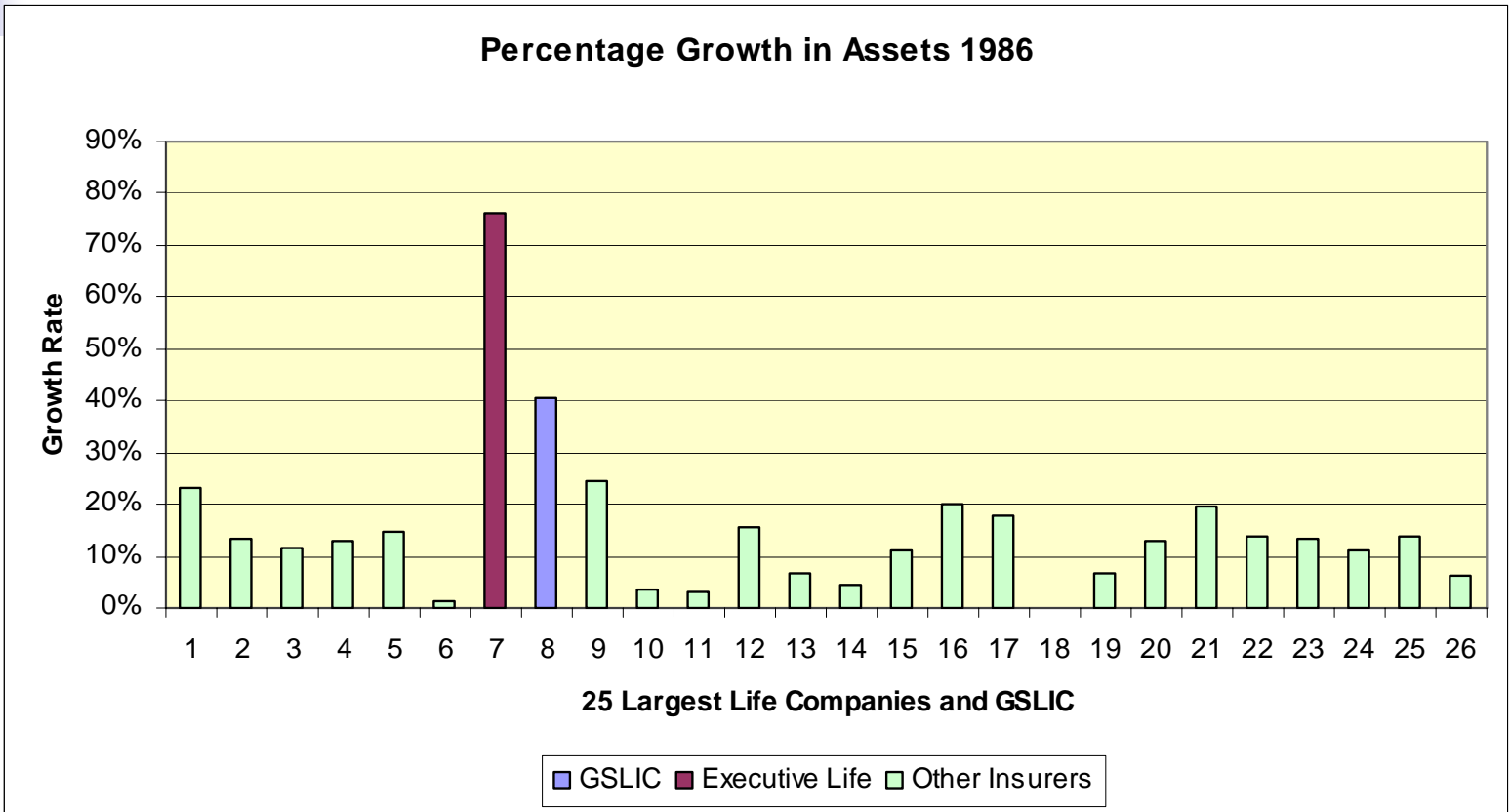
What warning for customers?

- Investment advisory journals?
 - Rated GSL annuity product #1 for value
- Rating Agencies such as AM Best?
 - No ratings for first 5 years
 - Adverse rating withdrawn at request of GSL in 1991
- Q. Didn't this marketing plan look eerily familiar to anyone?.....Baldwin United ??

Success...



Exceptional Growth





GSL's Business Plan - Wholesale

- Q. It is sooooo tedious to collect small sums from thousands of elderly retirees.
 - (Especially after being forced to cut bonus rates due to solvency problems)
- Isn't there a faster way to get control of large sums of money?



Assumption Reinsurance

- **Assumption Reinsurance is not reinsurance ...**

ABC has a portfolio of unprofitable business with reserves of \$100m

GSL agrees to accept full transfer of liability along with reserves of \$90m.

- ABC and GSL both very happy.



Assumption Reinsurance

- Policyholders: Not so happy

“I find it appalling that I could invest my money in an A-rated company only to have that investment shunted off a few years later to a relatively new, unrated company without my consent”.

- Policyholder consent was not required (and often policyholder was not even informed)



Protection for Policyholders?

- Was this legal? Apparently, yes.
- “Accepted practice” in the industry in the 1980s.
- Industry lobby groups fought hard to retain this set-up – it made it easy for them to get rid of unprofitable portfolios.



More Growth for GSL

- In the last 3 years before it went broke, GSL “assumed” 30,000 annuity contracts with a total value of about \$280 million from 4 other insurers.
- GSL’s Assets - close to \$1 billion.



Portfolio Transfers

- Q. How well-protected are Australian policyholders against transfers of insurance business which may be detrimental to their best interests ? (on either side)
 - ? FAI / HIH ??



Digression: Executive Life

- Executive Life was following a similar strategy, i.e. looking for access to money on a wholesale basis
 - Pension fund buyouts
 - “Hand over 90% of your pension fund and we will take the liability, you can keep the rest of the money”
- Q. If **you** were looking to obtain control of large sums of other people’s money in Australia, where would you look?



Regulatory Controls ?

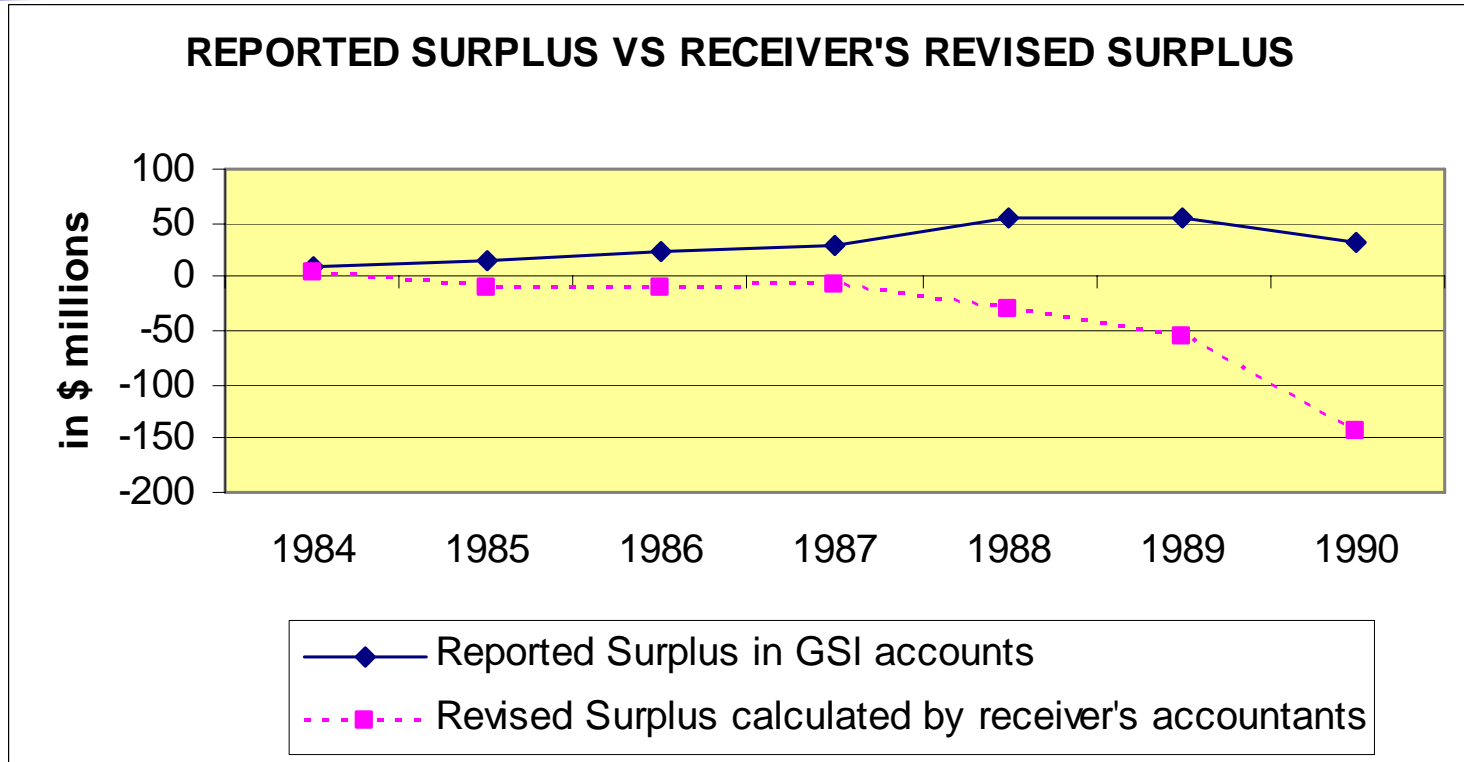
GSL grew from \$100m to almost \$1 billion in 5 years.

!What a successful company!

Businessman of the Year ??

Q. What regulations should prevent life insurers from pursuing this sort of business strategy?

How to Manage Solvency Requirements ?





Surplus Relief Reinsurance

Congressional investigation: Blackburn explained that the surplus relief reinsurance did not really protect the policyholders. The Senators were somewhat startled to hear this.

- *Senator: Do you mean the surplus relief reinsurance does not protect the policyholders and annuitants but for a couple of days?*
- *Blackburn: It is my impression – and it's not just my impression – the insurance industry has been in debate for the last few years about what really is surplus relief reinsurance. I can only tell you, basically as an insurance outsider, what the history is and what industry practice is on the use of surplus relief reinsurance.*
- *Senator: Well, why don't you tell us what you think it really does?*
- *Blackburn: Well it is my perception that it doesn't do very much but allow large companies to lend their surplus to small insurance companies for a fee.*



It's OK, everyone does it

- *Senator: Why doesn't that protect the policyholders ?*
- *Blackburn: Because it isn't money. If you were to liquidate the company, it wouldn't be there. It is merely a paper transaction.*
- *Senator: What do you think you're buying when you pay the premium for that?*
- *Blackburn: You are buying surplus that counts for statutory accounting.*
- *Senator: If you're trying to protect your policyholders, why don't you make sure you get the right kind of reinsurance? Isn't that your duty as president of the company?*
- *Blackburn: The duty of the president of the company is to follow industry practice and my advice from the experts – and the regulators. I mean, this is the entrenched system of allowing small companies to exist.*



Auditor / Regulator views

- *Senator: Were you at all concerned about the policyholders?*
- *Blackburn: No, I wasn't...I wasn't concerned about the policyholders with regard to the reserving because statutory accounting is overly conservative. Surplus relief seems to balance out that over-conservatism, and that's what industry practice has been.*

Auditors and actuaries agreed that the use of surplus relief reinsurance was common in the industry and often accepted by regulators.

- *"Most regulators are not opposed to surplus relief and in fact are often users or encouragers of surplus relief when they have a company which they are administering or regulating that has a surplus problem."*

TECHNICALLY, GSL met statutory requirements



Financial Reinsurance

- Surplus Relief Reinsurance is just another type of financial reinsurance – commonly used to cover up solvency problems
- Allows technical compliance with solvency requirements **without actually providing security for policy-holders.**
- Q. How do such practices become so widely accepted?
- *“If everyone else is doing it, it must be okay?”*

GSL's Investment Policy



The Financial Genius of the 1980s ?



Junk Bonds

- In order to offer such attractive annuity rates, GSL had to earn high returns
- They invested up to 90% of their assets in junk bonds (mostly purchased from Mr Milken / Drexel Burnham Lambert)

Q. What regulations should prevent an insurer from investing excessive amounts in high-risk assets?



Investment Restrictions

- **Attempts to limit junk bond investment in New York**

And I can tell you that we started thinking about a junk bond regulation in 1986. We were castigated both on Washington and Albany, told that we were doing the wrong thing, we were crazy, we were providing a situation where the consumer was going to get less value because of what we were doing, that we were going to ruin a good thing in terms of the junk bond market.... We were called to our own State Senate in Albany. A hearing was set up. The chairman of the committee questioned us very very rigourously as to why we would want to do this...

I think it was through the intestinal fortitude of, as I say, the civil servants and the intestinal fortitude of Governor Cuomo who got a lot of pressure at the time – from Drexel, which was flying high, from Fred Joseph [senior executive at Drexel], and from many many quarters, but had faith in his department.



Regulatory approval for junk bonds

Historically, it has been difficult to impose restrictions on investments when they are earning high returns – even when these investments are risky.

- *“Not a single other Florida-based insurer held a high-risk portfolio that approached the size of Guarantee Security’s. Its junk bond portfolio totalled, at one time, as much as 90 percent of its reported assets. It stood out like a sore thumb. **But the junk bonds produced an alluring income.** I think it’s fair to say that our department’s regulatory staff was as **blinded by the junk bond dazzle** as the rest of the nation’s financial industry.” (Gallagher)*



Special Approval for GSL

- *“What basically happened is we changed the junk bond law in Florida and made it very tough to own junk bonds by insurance companies, certainly not 90 percent...”*
- *“Well, Guarantee had 70 to 90 percent at that time in junk bond holdings, because remember they could not reverse those transactions anymore, and they came and asked us – remember, we don’t know what we know now – they would like to have an opportunity to sell them slowly, as opposed to selling them all at one time. “*
- *“I think, as good business judgement, I agreed when the staff brought it up to me whether we should do it, we looked at it and I said yes, that would be fine because it would not be good business practice to make them sell it all at once, when there really wasn’t a market for these.”*



Regulatory Forbearance ?

- Later, when everyone was trying to allocate blame for GSL's collapse, the Florida Department of Insurance was blamed:

"The principal cause of GSLIC's downfall was deliberate, regulatory acquiescence in the size of GSLIC's junk bond holdings."



Risk Based Capital Requirements

- MSVR : 20% of junk bond assets
- GSL's response: How to bypass?
- Solution:
 - MSVR calculated at year end
 - Sell junk bonds on 31 December
 - Buy back on 1 January
 - (same price plus fee)



Was it legal ?

Blackburn and other GSL executives argued that

- these trades were entirely legal;
- the transactions were properly recorded in the accounts; and
- the regulator was well aware of the trades and had no objection.



The Counterparty: Merrill Lynch

Q. Why did Merrill Lynch help?

[GSL] was not a big client of [Merrill Lynch] at that particular time. However the firm was making a very strong effort to try to catch up with Drexel Burnham, who was leading the parade in the high-yield area, and consequently it was put to me, and I think represented honestly, that if in fact we did this trade for the client that we could look forward to doing more secondary business with them plus primary business in the new area.

Coincidentally, a ML exec who made \$300,000 profit on a \$100,000 investment purchased from Sanford.



Did Merrill Lynch do anything wrong ?

Merrill Lynch's defence:

- It is quite legal to buy and sell securities
- If the trades resulted in a misleading presentation of GSL's solvency, that was not ML's responsibility.
- Merrill Lynch had no fiduciary responsibility to GSL's policyholders.

Despite denying all liability, ML did pay \$45 million to the FDI in settlement of a lawsuit relating to GSL.
SEC censured ML employees for poor record keeping.



Auditors: Coopers & Lybrand

- C&L were aware of the year-end transactions and their purpose
- Initially refused to sign financial accounts -> sacked
- They signed off the statutory accounts because:
 - Technically complied with statutory accounting requirements
 - The Florida Dept of Insurance knew and was okay with this
 - (At least, that's what Mark Sanford told them)
- Denying all liability, C&L later paid \$50 million to the FDI to settle a lawsuit relating to GSL



Florida Dept of Insurance

- *“We regulators were deceived. We believed the company’s officers and their attorneys; we believed the financial reports; we believed the accountants’ audits and the custodian bank’s confirmations. These reports and statements are supposed to disclose the company’s financial condition; instead, in the case of Guarantee Security Life, they hid it.”*

Somewhat disingenuous?



Did the regulators know ?

- FDI obviously knew GSL had 90% in junk bonds – they had intervened to allow it
- Year-end transactions were shown on the statutory returns
- Also in front page article in St Petersburg Times
- Amounts swapped were >60% of GSL's assets – noticeable?
- First draft of triennial investigation included adverse comment on year end transactions – apparently deleted from final version at GSL's request



Regulatory forbearance

*“The self-exculpatory statements from the commissioner from the regulatory agency are entirely inappropriate.... All of that talk about how “we were deluded” and the like, doesn’t really wash with me. I believe that what it is that happened was **they just didn’t want to blow the whistle because of the fact that it would create much too much turbulence** and therefore, in the regulatory process... to get along you go along.”*

(Briloff)



Revoking authorities

- Regulatory forbearance is a perennial problem
 - *"If we take any action it will cause a run..."*
- Politics
- In practice, how easy is it for a regulatory authority to revoke a large insurer's right to sell new business?
 - FAI???



The Junkiest of Junk

- The junk bond market crashed in 1989 (after Milken's arrest). But GSL's junk bonds crashed even more than most.
- GSL's Receiver:

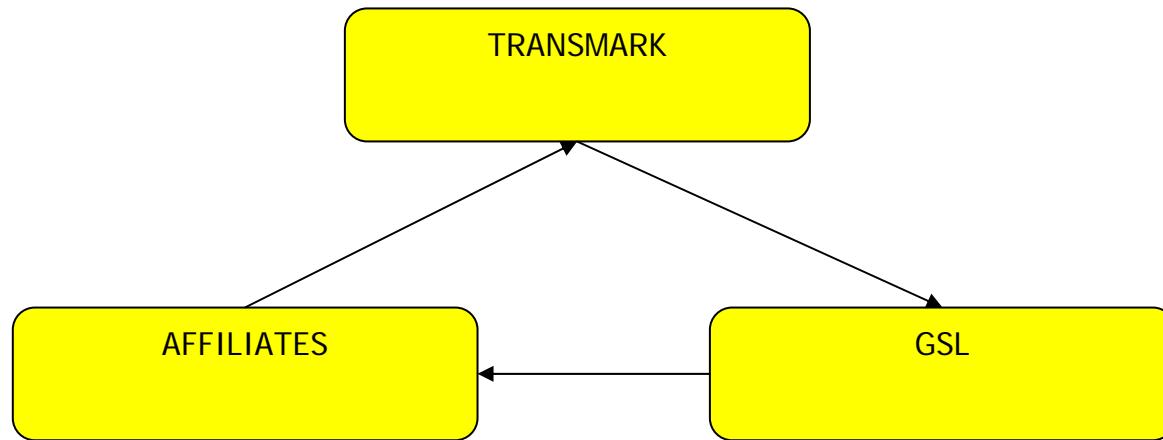
Thirty eight percent (38%) of the corporate bonds the company owned were in default; another 35% were extremely low quality issues near defaults and most of the remainder were of mediocre credit quality..”
- Just an honest mistake?



Milken's incentive scheme for investors

- “Equity Sweeteners” for Sanford and Blackburn (millions and millions of dollars)
 - But was it just a series of very very lucky investments ?
- Milken's \$150 million fund-raising for Transmark (GSL's parent company)
 - “Pass the parcel”
 - Investors (mostly S&Ls) later sued for misleading prospectus since bonds were worthless (Losses covered by taxpayers)
- After Milken was indicted (1989) he “co-operated” with SEC, which led to investigation of GSL.

Transactions with Affiliates



- GSL lent \$36m to affiliates
- Who paid \$36m in “dividends” to Transmark
- Who injected \$36 million in capital to GSL



Round Robin Deals

Q. What legislation should prevent this sort of deal ?

A. Florida had laws limiting investments in affiliates...but...



Was they really affiliates?

- A straw man owed the affiliates
- Transmark had options/warrants to buy all the shares
- And a legal agreement allowing Transmark to appoint the directors
- So technically, Transmark was not the owner; so they were not affiliates of GSL



More Lawsuits

The FDI sued:

1. Eminent Wall Street legal firm which set up the ownership deal. They said they had nothing to do with GSL's accounts - so not their fault.

(Paid \$5 million to settle)

2. Auditors (C&L) – who knew about these deals and signed the accounts anyway, because they were *technically* not affiliates.



Does White-Collar Crime Pay ?

- In the meantime, from 1984 until 1991, Sanford and Blackburn were busy looting GSL.

At the time of the collapse, the 38-year-old Sanford owned a million dollar beachfront home, a powerboat, two Lamborghinis, a Rolls Royce, two Corvette, and a Jaguar. He also owned his own small island in the Bahamas (only 363 acres).



Effectiveness of Sanctions ?

- Sanford's profits - ??? \$100 million
- Offshore, in wife's name, etc
- He agreed to pay about \$20 million to FDI
- In return, no prosecution against Sanford, Sanford's wife, or Sanford's brother.
- All three were barred for life from working in the insurance industry.
- It seems possible that Sanford might have had a few dollars left over, even after settling these claims.



A Victory for Policyholders?

- The Florida Insurance Commissioner announced that:
- *"This settlement is another victory for the 56,000 policyholders of GSLIC. We will not allow insurance companies to be mismanaged or looted, leaving policyholders to foot the bill"*



A Victory for Policyholders?

“A primary lesson that can be drawn from our experience with Guarantee Security is this: fortunately for consumers, the regulatory system in place in Florida, the home state of this company, worked.”

NB State guaranty funds paid out about \$180 million to cover GSL losses.



Questions to consider

Q. Who was responsible for GSL's losses?

A. Apparently, no one.

No one went to jail.

No one admitted wrong doing.

Everything was legal and in accordance with accounting standards.



Conclusion

- *“The most distressing aspect of this sordid saga is the recognition that over a half dozen year of perversity, tens and perhaps hundreds of people in responsible positions were wallowing in the Stygian Swamp. Thus they were in that stinking quagmire, concocting transactions, producing fake documents, rationalising evil by some exotic rules of GAAP or its regulatory equivalent, and not one of them found it necessary to blow the whistle to put an end to that nest of vipers”*
(Briloff)