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Cracks Starting to Show? Fallout From Collateral Issues with Vesttoo

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Background

It's tough times for the U.S. property & casualty (P&C) Industry. Tough times for insureds who confront ever higher rates in most lines of business, for (re)insurers which are struggling to right-size pricing in the teeth of inflation and a volatile loss environment, and for regulators who, in personal lines especially, are caught between the conflicting demands of the first two. In addition, wholesale distributors vie for diminished capacity while retail producers lament market exits and spiking rates. Investors, for their part, wonder when the market will regain some sort of consistent footing.

The current hard market in the U.S. P&C market began in 2018 after over a decade of mostly soft pricing. This was accompanied by an acceleration of large weather-related losses, both primary and secondary, as the world faced (and continues to face) an increasingly errant climate. Then came two plus years of Covid which turned the world's economy upside down, followed by run-away inflation which, in retrospect, seemed somewhat predictable given emergency measures taken to combat the severe pandemic-induced recession of 2020. In the meantime, the persistence of social inflation and war in Central Europe has provided additional challenges.

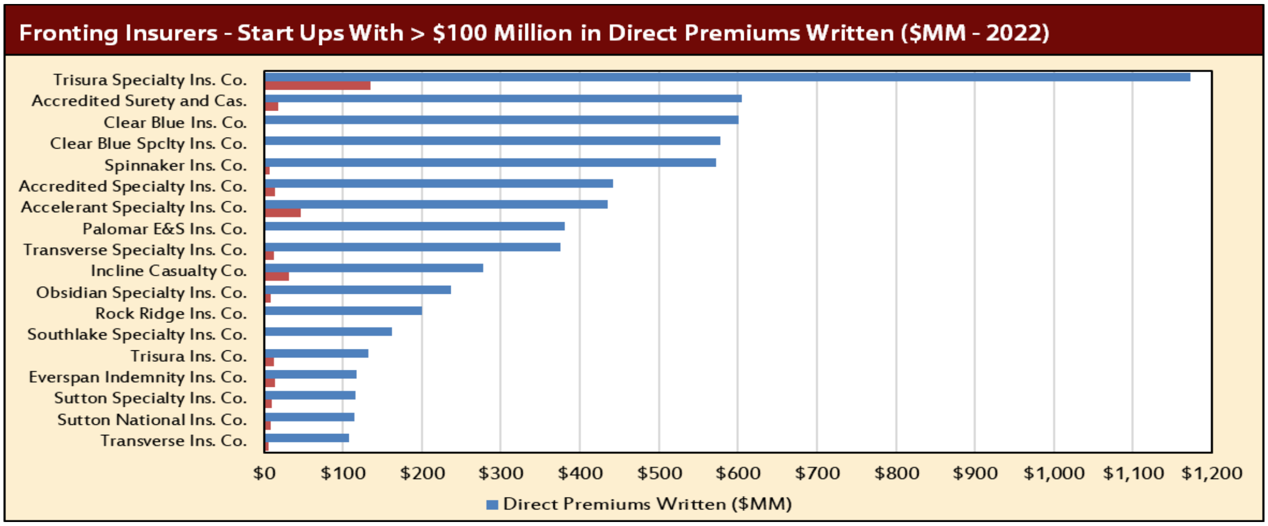
As all of this was unfolding, the private investment world stood awash in cash. Interest rates had remained low for well over a decade, a situation that only accelerated with the onset of the pandemic. The insurtech revolution proceeded apace (with every new idea a purported game-changer). Investors were seeking risks uncorrelated to traditional capital market returns and money poured into the insurance industry. As the more lightly regulated excess & surplus lines sector responded to market dislocations, this seemed the place to be. As a result, we have witnessed a deluge of newly sprung specialty insurers and distributors. Rating agency A.M. Best continues to play its part by issuing critical "A-" ratings at the mere whiff of experienced management, some minimal level of surplus, and a good story.

Whenever a surplus of eager money meets new ideas and opportunities, excesses are bound to follow. These excesses breed carelessness and, inevitably, shortcuts are taken and cracks begin to show. In our opinion, this is precisely what we are experiencing with fronting and other specialty P&C carriers vis-à-vis the recent fallout from fraudulent letters of credit (LOC) which could result in losses of hundreds of millions of dollars.

Vesttoo, Fronting Carriers, and Importance of Reinsurance Collateral

Vesttoo is an insurtech platform founded in 2018 by three Israeli entrepreneurs. Vesttoo's vision, simply stated, is to facilitate the investment of third-party capital in the (re)insurance industry. The company has grown rapidly, achieving unicorn status (a private valuation of over $1 billion) in late 2022. In its initial years it did not own its own reinsurance entity, instead sourcing insurance programs for other third-party reinsurers. In 2022, the company launched its own reinsurance entity, Vesttoo Alpha P&C, which was however recently placed into liquidation by the Bermuda Monetary Authority.

The Vesttoo platform is closely tied to the fronting company structure, which has also experienced rapid growth over the past decade. **Based on ALIRT's upcoming review of the fronting carrier market, there are close to 20 fronting carriers launched in the past 10 years with over $1 billion of direct premium written (DWP) in 2022**. As shown below, these insurers cede the vast majority of their DWP to mostly third-party reinsurers, earning fees for "lending" their balance sheets to these (often offshore) reinsurance entities.



The fronting model depends critically on the recovery of reinsurance payments when losses occur, as the primary insurer (the policy's "issuing carrier") is ultimately responsible for paying the claims. Some reinsurance counterparties are well-established entities that are either domiciled in the U.S. or have earned the imprimatur of U.S. state regulators (and therefore are considered authorized or certified). Fronting insurers earn surplus credit for the reserve recoverables from such insurers.

For other "unauthorized" reinsurers, the fronting companies must secure collateral to cover estimated reinsurance payments. Without this collateral, the fronting company would need to report more of the gross reserve on its balance sheet, diminishing surplus. This collateral can take several forms, including funds withheld, trust funds, or letters of credit (LOCs), all of which are required to be reported annually on an insurer's statutory financial statement.

Vesttoo's platform, beyond sourcing insurance programs for investors, also helped to source required collateral. In mid-July, news broke that a number of LOCs sourced via Vesttoo and purportedly issued by the China Construction Bank Corporation (CCB) were fraudulent. This news caused a panic among primary insurers (mostly fronting company specialists) which, absent this collateral, could face a substantial hit to surplus either via unexpected losses and/or the re-statement of reserves. Wholesale and retail (re)insurance distributors, which helped broker the impacted policies, could also face potential legal actions from insureds that depended on their conducting appropriate due diligence.

On the following page, ALIRT lists the potential exposure to surplus faced by individual insurers that have counterparty exposure to CCB LOCs (via statutory Schedule F filings from YE2022). ***While it is impossible for us to determine how much of these CCB LOCs are legitimate[1], we provide here a "sweep" of all CCB LOC exposure, if only to show how U.S insurers can build up surplus exposure to the LOCs of a single banking organization over time.*** We note that a number of these insurers with ties to Vesttoo (and thus potentially fraudulent LOCs) have already proactively sought to replace the LOCs in question[2] with new collateral agreements and these efforts are on-going.

As shown, the surplus exposure of six insurers to this questionable collateral is approximately 100% or more, with CCB LOC's representing over 300% of year end 2022 surplus positions for three carriers. These latter

[1] CCB is one of the largest banks in China, ultimate owned by a Chinese government holding company. CCB has branch offices in most of the global money market centers, including London, New York, Toronto, Tokyo and Zurich.

[2] For example, as of August 8, 2023 the Clear Blue Group states that it has found replacement collateral for 90% of its CCB-related LOCs. Corinthian Group, which owns Coastal Insurance SPC, Corinthian Re, and onshore reinsurer Osprey Re, is also making efforts to replace collateral sourced through the Vesttoo platform.

include **Homeowners of America Insurance Company** (owned by insurtech Porch Group, with largely Texas homeowners coverage), **Clear Blue Insurance Company** (homeowners and commercial auto exposure, with premium concentrations in Texas and Florida), and **American Millenium Insurance Company**, a Citadel Re affiliate with commercial auto liability exposure, largely in New Jersey.

The three other carriers with especially elevated exposure include three Texas county mutual insurers whose business model is largely fronting Texas non-standard auto coverage. As with American Millenium, the CCB LOCs backing the county mutual reinsurance transactions were sourced through insurer subsidiaries of The Corinthian Group which is known to have used the Vesttoo platform and, as footnoted above, is actively seeking to replace this fraudulent collateral.

Exposure to LOCs issued by China Construction Bank Corp. as of 12/31/2022

NAIC Code	Insurer Name	LOC Amount $000	Insurer PHS $000	LOC/ PHS
12536	Homeowners of America Insurance Company	300,000	76,143	394.0%
28860	Clear Blue Insurance Company	360,548	107,620	335.0%
26140	American Millennium Insurance Company	24,583	8,086	304.0%
29297	Home State County Mutual Insurance Company	9,848	9,472	104.0%
29300	Redpoint County Mutual Insurance Company	9,105	8,916	102.1%
29378	Old American County Mutual Fire Insurance Company	4,831	5,000	96.6%
37745	Clear Blue Specialty Insurance Company	164,377	176,618	93.1%
11089	Rock Ridge Insurance Company	16,345	21,255	76.9%
28339	Gateway Insurance Company	9,253	12,141	76.2%
21075	Transverse Insurance Company	16,668	32,934	50.6%
22390	Aventus Insurance Company	12,969	26,337	49.2%
11665	Old American Indemnity Company	5,629	11,732	48.0%
16188	Trisura Specialty Insurance Company	72,172	154,072	46.8%
11090	Incline Casualty Company	34,142	74,729	45.7%
16777	Highlander Specialty Insurance Company	36,073	115,883	31.1%
35319	United Automobile Insurance Company	24,354	95,908	25.4%
10974	Root Insurance Company	18,571	77,005	24.1%
18430	Agricultural Workers Mutual Auto Insurance Company	8,736	36,408	24.0%
16890	Accelerant Specialty Insurance Company	15,187	67,528	22.5%
16999	Southlake Specialty Insurance Company	14,768	66,584	22.2%
39152	Service American Indemnity Company	5,249	24,969	21.0%
16524	Clearcover Insurance Company	4,748	24,093	19.7%
25798	Sutton National Insurance Company	8,516	43,805	19.4%
17151	Concert Specialty Insurance Company	10,662	57,544	18.5%
26379	Accredited Surety and Casualty Company, Inc.	7,396	72,462	10.2%
37028	Citizens United Reciprocal Exchange	1,953	19,620	10.0%
14167	GuideOne National Insurance Company	5,013	50,941	9.8%
10839	Country-Wide Insurance Company	2,508	26,137	9.6%
16848	Sutton Specialty Insurance Company	8,926	101,306	8.8%
22225	Trisura Insurance Company	15,559	181,273	8.6%
15032	GuideOne Insurance Company	30,133	389,436	7.7%
20338	Palomar Specialty Insurance Company	23,453	313,900	7.5%
10220	Accelerant National Insurance Company	1,711	24,166	7.1%
28746	Equity Insurance Company	1,717	30,318	5.7%
10051	Lyndon Southern Insurance Company	6,512	170,813	3.8%
41807	Transverse Specialty Insurance Company	4,040	114,090	3.5%
10480	Glacier Insurance Company	225	6,529	3.4%
10891	Concert Insurance Company	860	30,595	2.8%
25860	Union Mutual Fire Insurance Company	2,205	114,733	1.9%
10970	Response Indemnity Company of California	310	16,278	1.9%
16823	Fortegra Specialty Insurance Company	1,303	69,592	1.9%
16014	New Horizon Insurance Company, Inc.	239	17,080	1.4%
29149	Kentucky National Insurance Company	58	5,767	1.0%
16835	Accredited Specialty Insurance Company	740	74,103	1.0%
43389	Service Lloyds Insurance Company	1,327	138,522	1.0%
40754	Blue Ridge Indemnity Company	24	16,388	0.1%
10166	Accident Fund Insurance Company of America	2,467	1,698,916	0.1%
11162	Insurance Company of the South	42	44,171	0.1%
17166	Bricktown Specialty Insurance Company	10	49,964	0.0%
Totals		**1,306,065**	**5,111,878**	**25.5%**

The vast majority of companies with surplus exposure to CCB LOCs of 30% or more are involved in fronting arrangements, and include subsidiaries of some of the larger fronting groups (i.e. Clear Blue, Gateway, Incline/Merfax, Transverse, and Trisura). The Clear Blue Group appears especially exposed, with all four of its principal insurer subsidiaries reporting CCB LOC's equaling 30% or more of YE2022 surplus. Moreover, these insurers were known to have a close partnership with the Vesttoo group.

The insurer entities of other fronting specialists, such as Accelerant Holdings, Accredited Group, Concert Group Holdings, Southlake Financial, and Sutton National/Sutton Specialty have much more manageable exposures (of under 25% of year end 2022 surplus).

Lastly, we note that a number of exposed insurers are lead carriers within insurtech groups[3]: Homeowners of America Insurance Company (Porch Group, Inc.), Root Insurance Company (Root Inc.), and Clearcover Insurance Company (Clearcover, Inc.).

As regards public ratings coverage of the companies in question, all of the major fronting groups listed above currently carry A.M. Best

[3] For more on P&C Insurtechs, please see ALIRT's September 2022 release "ALIRT Research: Insurtech Carriers Under Pressure"

"A-" ratings, though the Clear Blue Group subsidiaries were recently placed under review with negative implications given their outsized exposure to the fraudulent LOCs in question. In addition, A.M. Best placed the A- rating of both Trisura Specialty and Trisura Insurance Company on Negative Outlook in March of this year given collateral issues in 2022 which resulted in the group reporting a $60 million charge.

Homeowners of America Insurance Company, as with most insurtech start-ups, remains unrated by A.M. Best as do the three Texas County Mutuals toward the top of this list. American Millenium Insurance Company, for its part, has seen its A.M. Best rating sharply downgraded over the past three years from B+ (6th highest) in 2019 to D (13th highest) in May 2023 when it was removed at management's request.

Below we provide a table that shows select fronting/insurtech insurers with surplus exposure to CCB LOCs of over 10% as of year end 2022. These insurers appear to have accessed some of these LOCs through the Vesttoo platform, with reinsurance counterparties including in a few instances Vesttoo Alpha P&C Ltd. (now being liquidated) and White Rock Insurance (SAC) Ltd. (owned by Aon), but largely via the Corinthian Group subsidiaries mentioned above.

Insurer	Parent	Reinsurer	CCB LOC ($MM)
Homeowners of America Ins. Co.	Porch Group, Inc.	White Rock Ins. (SAC) Ltd.	300
Clear Blue Insurance Company	PBRA (Cayman) Co.	Osprey Re	6
		Vestoo Alpha P&C Ltd.	91
		White Rock Ins. (SAC) Ltd.	218
Clear Blue Specialty Ins. Co.	PBRA (Cayman) Co.	Clear Blue Re, Inc.	10
		Vestoo Alpha P&C Ltd.	2
		White Rock Ins. (SAC) Ltd.	152
Rock Ridge Insurance Company	PBRA (Cayman) Co.	White Rock Ins. (SAC) Ltd.	7
		Undetermined	9
Gateway Insurance Company	Buckle Corp.	Osprey Reins. Co. Ltd.	9
Transverse Insurance Company	MS&AD Ins. Grp.	Osprey Re (Captive)	17
Trisura Specialty Insurance Co.	Trisura Group Ltd.	Corinthian Reins. Co.	*n/a*
		Osprey Re	*n/a*
Incline Casualty Company	Merfax Fin'l Grp.	Osprey Re (Captives)	34
Highlander Specialty Ins. Co.	PBRA (Cayman) Co.	Osprey Re	1
		White Rock Ins. (SAC) Ltd.	35
Root Insurance Company	Root Inc.	Osprey Re (Captive)	19
Accelerant Specialty Ins. Co.	ACP Ins. Mgt.	Corinthian Reins. Co.	13
		Undetermined	2
Southlake Specialty Ins. Co.	Southlake Fin'l Hldgs.	Osprey Re (Captive)	15
Clearcover Insurance Company	Clearcover, Inc.	Corinthian Reins. Co.	5
Sutton National Insurance Co.	777 Partners LLC	Osprey Re (Captive)	9
Concert Specialty Ins. Co.	Concert Group Hldgs.	Corinthian Reins. Co.	0
		Freedom Reins. U/W	1
		Osprey Re (Captives)	10
Accredited Surety & Cas. Co., Inc.	R&Q Ins. Holdings Ltd.	Corinthian Re SPC	4
		Osprey Re (Captives)	3

Conclusion

All of the parties exposed to the recent fraudulent LOC's – wholesale brokers (Managing General Agents and Program Managers), their reinsurance broker partners, the issuing insurers and their reinsurance counterparties, as well as the Vesttoo platform itself – bear some responsibility for the current mishap with fraudulent LOCs issued by CCB. While we concede that this was likely a well-designed fraud, it is difficult to fathom that it was able to evade multiple levels of due diligence purportedly carried out by these different participants. That is, unless corners were being cut in the race to place premium into difficult corners of a difficult P&C market.

And, as stated at the outset, this is precisely what ALIRT is concerned about given the surge of new distribution and insurance entrants into the specialty P&C insurance market over the past number of years. We have already seen two missteps out of this sector of the market over the past year, including fake policies issued by James Allen in 2022 and the aforementioned collateral dispute costing fronting specialist Trisura tens of millions of dollars earlier this year. Now this. One wonders if there will be more.

In the meantime, ALIRT remains laser-focused on the rapid growth of many of these relatively recent start-ups (especially in the fronting sector), which will necessitate either on-going surplus support from parents, substantial dependence on reinsurance, or both. ALIRT's analyses necessarily focus on the balance sheet of insurers as they evolve from quarter to quarter, including importantly an insurer's surplus exposure to operational mishaps such as unrecoverable reinsurance payments.

With the current ALIRT Scores of many of the carriers exposed to the CCB LOC fiasco towards the lower end of our historically normal range (or below), they necessarily have less wiggle room for mistakes. With the A.M. Best A- rating so liberally distributed to start-ups in recent years, we suggest that clients continue to closely track the ALIRT profiles of any of their newly-minted specialty insurance partners.

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