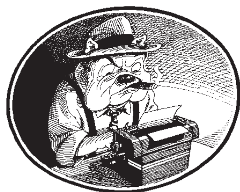

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General American's Strange Transactions

$500 Million of Hidden Losses?

Troubling Secrecy Agreement

MetLife to Pay $1.2 Billion

WHEN IT BECAME CLEAR, in the second week of August, that General American, a supposedly staid life insurer, was running its balance sheet as if it were a leveraged hedge fund, it also became clear that General American couldn't remain an independent company.

Although General American and MetLife haven't disclosed the magnitude of General American's losses that resulted from issuing $6.8 billion of funding agreements—many with 7-day put provisions—and investing the proceeds in medium-term securities, our estimate is that the loss is between $400 million and $600 million.

We've arrived at this figure several ways. First, it's highly unlikely that MetLife would be able to buy General American for a price approximating its marked-to-market statutory surplus. (General American's year-end surplus was $1.3 billion, and MetLife is paying $1.2 billion.)

Second, General American engaged in one of the most foolhardy financial speculations, borrowing short and lending long. Since interest rates have risen in the last year, it's reasonable to assume that General American's fixed maturities have declined in value. If they have declined 5% as a result of higher interest rates, that translates into a loss of $340 million based on $6.8 billion of assets.

Perhaps equally troubling, is the widening of credit spreads, which would have increased General American's losses further. ("Credit spreads" are the difference in yield between lower-rated debt and higher-rated debt.) Although General American chose not to discuss its asset/liability matching strategy with us, it's our understanding that the company invested heavily in private placements and corporate securities. While one might call these securities "illiquid," that does not mean they're unsaleable. The price at which these securities could be sold, however, was considerably lower than the price that General American wanted to receive—and needed to receive.

Thus, General American was exposed to a triple whammy: its short-term liabilities came due at a time when its long-term assets had declined as a result of interest-rate and credit conditions.

The ARM Agreements

A recent SEC filing made by ARM Financial Group sheds light onto the General American situation, and raises interesting issues.

Effective July 26, 1999, the master agreement between ARM, its subsidiary Integrity Life Insurance Company, and General American, was terminated. At that time, customer account values subject to the reinsurance agreement between Integrity and General American totaled $3.428 billion.

Apparently, Integrity commuted its reinsurance agreement with General American by returning the $3.428 billion of liabilities to General American, along with assets in a trust fund that were supporting these liabilities.

But that's not all Integrity gave General American. It removed two securities from the trust fund (presumably because they were impaired) and replaced them with a security that had a par value of $10.14 million. It also threw in a $69.15 million cash payment.

Without a complete financial picture—which General American has been unwilling to provide—it's difficult to know exactly what was taking place and why. Although it appears that General American was able to squeeze $79.29 million out of Integrity because Integrity was desperate for a deal, that may not be the full story.

As part of the "termination agreement," General American paid ARM—which is a holding company rather than an insurance company—a $51.5 million "recapture fee." In addition, General American lent ARM $38 million. (It appears that this loan is already in default, and General American's odds of a full recovery don't look good: ARM's stock has collapsed [the last trade was at 25¢], its shares have been delisted, and Integrity has been put under regulatory supervision.)

Thus, General American, which received an additional $79.29 million from Integrity Life Insurance Company, turned around and, through payments and loans, gave $89.5 million to ARM. The result, it seems, was that ARM, which is not an insurance company, received $89.5 million at the same time that its insurance company, Integrity, was being drained of $79.29 million.

The losers in this transaction may be Integrity's policyholders. If Integrity is unable to meets its obligations, that extra $79.29 million may become a point of contention.

Rating Agencies in the Dark

General American and ARM wanted to keep the details of their transaction a secret. One provision of the agreement is particularly fascinating: "ARM will not issue any press releases, make any public filings, *or make any presentations to any rating agencies* [emphasis added] which include references to the transactions contemplated hereby without consulting with General American and receiving the prior approval of General American." Did General American hope that by preventing ARM from making a presentation to rating agencies that it (General American) would be able to maintain its ratings or avoid a downgrade? Did General American hope that it could slip its massive and misguided speculative bet—which had just blown up—past the rating agencies, and, ultimately, past the public?

If that was the company's intention, it failed.

Moody's, demonstrating grace under pressure, did something that most rating agencies are loathe to do: it downgraded General American, which prompted a run on the company. Some have criticized Moody's action, suggesting that everything would have been fine if it had given General American time to work out its massive problems.

But Moody's—or any rating agency—isn't in the business of granting reprieves to weak credits. It's in the business of giving an honest and fair opinion of a company's financial strength—regardless of what the ramifications of that opinion might be.

Several financial analysts and journalists told me that they thought Moody's had acted inappropriately—that it should have waited before downgrading General American. That's ridiculous. If an analyst came across material negative information about a company whose stock he was recommending, you can bet that he'd be on the phone with his big clients as quickly as possible. And if a good reporter uncovered the same information, he'd work feverishly to break the story.

General American gambled and lost. Moody's did what it was supposed to do. And MetLife is trying to act opportunistically and pick up some troubled merchandise at a good price.

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