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Night of the Living Dead?

Reliance's Unicover Fiasco

Can Cedants Collect from Reliance?

RELIANCE GROUP HOLDINGS AND its primary subsidiary, Reliance Insurance Company, are in dubious financial condition. There's a distinct possibility that Reliance Group might default on its debt and that Reliance Insurance Company might fail.

Reliance's plight is the result of years of risk-taking. Chairman and CEO Saul Steinberg has compounded the *operating-and- balance-sheet leverage* inherent in an insurance company by employing *investment leverage* (junk bonds and big stock bets) and piling on *financial leverage* at the holding company level. (Reliance Group Holdings' debt burden and hefty dividend on its common stock necessitate that Reliance Insurance Company upstream a significant amount of money—primarily through dividends—to Reliance Group Holdings. This has contributed to the insurance company's weaker capitalization.)

Steinberg also made the mistake of growing Reliance National too rapidly. In financial services, rapid growth generally equates with increased risk, and is only prudent for companies with strong balance sheets. (Reliance National writes big accounts—just the sort that are likely to head for the exits at the first whiff of financial distress.)

Not since November 1994, when we wrote that "The Home is no longer a viable operation," have we seen a giant property-casualty insurance company in as worrisome financial condition as Reliance is in now. (Although The Home was one of the "living dead," it wasn't put under formal state supervision until March 4, 1997, and Best didn't downgrade it from B- to E until March 10, 1997.)

We've been writing about Reliance and Steinberg since 1992, and except for noting (in our first article) that Reliance Insurance *Company's* preferred stock was a good buy, haven't had much positive to say. But we've kept on writing about Reliance and Steinberg because Reliance is a major insurance company that continuously engages in fascinating transactions and Steinberg is a financial Zelig: whether the fad was computer processing, mergers, financial-services holding companies, takeovers, hostile takeovers, pooling accounting, junk bonds, LBOs, Drexel Burnham, spinoffs, stock buybacks, IPOs, or Mike Milken—Steinberg was there.

We've also noted Steinberg's remarkable ability to issue securities at prices that the buyers of those securities would regret, and have been amused by his chutzpah in forming an "African-American owned" insurance company in which he was the de facto control shareholder.

Since August we've written four articles about Reliance, for the most part focusing on its less-than-stellar financials and vulnerability to a rating-agency downgrade. We have not, however, used much ink on some of the details of its involvement in the Unicover fiasco, and what this means for Reliance, the insurance companies that ceded it business, and insurers that have reinsurance recoverables from Reliance.

What is Unicover?

Unicover is an underwriting manager that supposedly had special expertise in the workers' compensation market. It set up programs that, in effect, would allow insurance companies to transform unprofitable workers' compensation premiums into profits via a reinsurance arbitrage that involved the conversion of primary workers' compensation into life-health reinsurance. This was accomplished by "carving out" the small portion of workers' compensation premiums that are considered casualty coverages, and reinsuring the remaining business (injury, disability, death and dismemberment, etc.) with a life-health reinsurer. Because a life-health company can't write casualty coverages, a property-casualty "front" company—Reliance, for example—was used as a conduit. Reliance evidently believed that it was possible to make a significant amount of money fronting an estimated $1.7 billion of premiums (based on two-year programs) without taking any risk whatsoever. The primary carriers that used Reliance as a front evidently believed that doing so involved negligible risk. (A reinsurer's failure to make good on its reinsurance obligations does not relieve a primary insurance company of its obligations.)

The winners in the Unicover reinsurance arbitrage were (or would have been) the following: the primary insurance companies that got ceding fees; Reliance, which got fronting fees and other revenues; the intermediaries who took a piece of the action at various points in the process; and insureds who were able to buy insurance at rates that were too cheap. (See the table on page 2: *Reinsurance, Hollywood Style: Reliance's Involvement in the Unicover Fiasco*.)

Since this reinsurance arbitrage was a zero-sum game, there had to be losers for every winner. The losers were, or would have been, Reliance's retrocessionaires: Sun Life, Phoenix Home Life, and Cologne Life Re. (Sun Life has estimated that its losses, not all from Reliance, are between $700 million and $900 million. Phoenix's losses would be the same as Sun's since it had the same exposure. Earlier this year Cologne said that its loss, not all from Reliance, would be $275 million.) To the extent that Sun and Phoenix retroceded business, their retrocessionaires would be losers.

Based on information gathered from various sources, we've estimated that the primary carriers whose business flowed through Reliance stand to make $650 million, that Reliance stands to make $100 million, and that Reliance's retrocessionaires stand to lose $1.09 billion.

Continued

If only it were so simple. Numerous parties in the Unicover mess have filed lawsuits or sought arbitration. Sun and Phoenix want to invalidate their Unicover contracts, and so do some of their retrocessionaires. Reliance has said that it believes that it has valid reinsurance and, indeed, that's possible. Reliance's problem, however, is that time is its enemy. It is already in a weakened financial state and faces rating-agency downgrades that could put it out of business. Furthermore, it will have a difficult time writing and retaining business until its financial problems are solved, and the Unicover cloud of uncertainty is lifted.

Unrecoverable Reinsurance?

It's our understanding that Reliance's retrocessionaires would like to settle matters—but not for $1.09 billion. They believe that they were tricked (not by Reliance) into participating in a disastrous reinsurance scheme and that their contracts will eventually be voided. Of course, the retrocessionaires don't know what a court might decide, and since they're all big boys with considerable balance sheets, it's in their interest to pay some money now to make their problem go away.

Reliance, too, would dearly love to make its problem go away because—unlike its retrocessionaires—its survival may depend on that. But Reliance is caught in the middle. Probably the only way that it can solve its problem is by convincing its cedants to commute their reinsurance deals for less than 100 cents on the dollar. Here's the catch: if the cedants (see page 3) believe that Reliance is unquestionably solvent, they have no reason to settle. After all, depending upon their situation, they'd be losing money, forgoing profits, or, in some cases, taking massive losses.

Let's say that Reliance's retrocessionaires are willing to give Reliance $200 million to end their reinsurance agreements. Reliance would accept that only if it could concurrently convince its

Reinsurance, Hollywood Style: Reliance's Involvement in the Unicover Fiasco

In Hollywood, everyone knows that you always want to own a piece of the "gross," not a piece of the "net." In the Unicover workers' compensation spiral, however, primary carriers, reinsurance brokers, and fronting companies attempted to do the impossible: make net profits from gross losses.

This process (shown below) involved the conversion of primary workers' compensation premiums into life-health reinsurance. This is accomplished by "carving out" the small portion of workers' compensation premiums that are considered casualty coverages, and reinsuring the remaining business (injury, disability, death and dismemberment, etc.). Because a life-health company cannot (in theory) write casualty coverages, a property-casualty fronting company—in the figures shown below, Reliance—was used as a conduit. Reliance evidently believed that it was possible to make a significant amount of money without taking any risk whatsoever. And many primary companies apparently believed that there was negligible risk in using Reliance as a front.

The table below tracks the premiums and the losses as they flow from (1) primary carriers to (2) the fronting company, Reliance, to (3) the retrocessionaires. At every step of the way, fees were earned by intermediaries: reinsurance brokers (primarily E.W. Blanch, AON, and Sedgewick), fronting companies (primarily Reliance), and reinsurance underwriting managers (primarily Unicover). The final column (4) shows what Reliance would make under the program.

all figures in thousands of dollars		**1) Primary Carriers** Primary Carriers create profits out of otherwise unprofitable workers' compensation business by availing themselves of reinsurance from Reliance (via a Unicover underwriting facility)...	**2) Reliance and Unicover** Reliance reinsures the primary carriers under a "fronting" arrangement. The gross results for Reliance's underwriting facilities involving Unicover are terrible, but…	**3) The Retrocessionaires** Through the magic of reinsurance, the losses are passed on to Reliance's retrocessionaires—Sun Life, Phoenix Life, and Cologne Life—saddling them with whopping losses but leaving…	**4) Reliance "Risk-Free" Profit** Reliance with a "risk-free" profit…if nothing went awry.
Revenues					
Premiums (Ceded)	$	(1,400,000)	1,400,000	650,000	750,000
Ceding Commission		350,000	(350,000)	0	(350,000)
Total		**(1,050,000)**	**1,050,000**	**650,000**	**400,000**
Claims and Expenses					
Losses (Ceded)		(1,700,000)	1,700,000	1,700,000	0
Intermediary Fees & Other Expense		0	250,000		300,000
Retrocessional Brokerage		0	0	40,000	0
Total		**(1,700,000)**	**1,950,000**	**1,740,000**	**300,000**
PROFIT	**$**	**650,000**	**(900,000)**	**(1,090,000)**	**100,000**

The figures above—based on multiple sources—are estimates for the Unicover workers' compensation reinsurance treaties (the Reliance facility and the Lincoln National facility) in which Reliance "fronted" premiums that were retroceded to Sun Life, Phoenix Home Life, and Cologne Life. Most of the treaties were two-year programs, and the figures above assume that the programs go the full term. We have made adjustments to the data from which these figures were derived, including recharacterizing and combining certain items. Revenues and expenses are shown in a simplified manner that we believe make them more easily understood. (Some of the figures are more precise than others. Estimated premiums, for example, are inherently more quantifiable than estimated losses.)

cedants to take a haircut on what they are owed.

This is a giant game of chicken, with different companies in different negotiating positions. FCCI, for example, used American Re as a front. (American Re then ceded the business to Reliance.) As a result, it's hard to imagine FCCI taking less than what it is contractually owed.

At the other end of the spectrum might be PAULA Insurance Company, which says that it will make $25 million to $30 million on the business it ceded to Reliance. PAULA has about $50 million of surplus—and $50 million or so in reinsurance recoverables from Reliance. If Reliance were to fail soon, PAULA would be in big trouble. That ought to give it an incentive to settle with Reliance. On the other hand, how big a haircut can PAULA *afford* to take? *Not much*, is our guess.

In order to negotiate a settlement with the majority of its cedants, Reliance will, in all likelihood, have to pay out considerably more than it receives from its retrocessionaires. But Reliance, which has financial problems other than Unicover, doesn't have deep pockets. Can it shell out $400 million and keep its ratings? How about $300 million? Or $200 million?

No one can say how the situation will play out. The rating agencies, however, are cutting Reliance considerable slack and hoping for the best.

At this moment, however, Reliance is vulnerable and doesn't deserve the ratings it has. Brokers and insureds should realize that Reliance carries a significant speculative element—something one is not usually looking for in an insurer.

Each day that passes without a resolution may only worsen Reliance's predicament. Renewals will be hard to sell and new business will be difficult to write. That would only make it more difficult for Reliance to raise capital, refinance its debt, and, ultimately, survive.

Ironically, Reliance's best negotiating point may be the fact that it is so weak: if it fails, its cedants will have to line up behind every Reliance policyholder before they are paid. But how can Reliance convince its cedants that it's so weak that they should take a big haircut, while it's telling brokers, insureds, and the financial community that it is sound?

That leaves us with a conundrum: Reliance's weakness may do it in, yet the fact that it is so weak could be the very thing that saves it.

How to Make Money Writing Workers' Compensation in a Soft Market

Workers' compensation premiums fronted through Reliance.

Primary Insurance Company *all figures in thousands of dollars*		Primary Insurance Company cedes premium...		receives a ceding commission		and cedes losses...		leaving it with an underwriting gain.
Bridgefield Employers Insurance Company	$	(150,000)	+	60,000	+	115,000	=	25,000
Colorado Compensation Insurance Authority		(220,000)		30,000		280,000		90,000
FCCI Mutual Insurance Company[1]		(100,000)		30,000		130,000		60,000
Fremont Compensation Insurance Company		(135,000)		35,000		170,000		70,000
Great American/Ohio Casualty Insurance Company		(60,000)		12,000		72,000		24,000
HIH Compensation and Liability Insurance Company		(135,000)		15,000		235,000		115,000
Insurance Company of the West		(40,000)		5,000		50,000		15,000
National American Insurance Company of Oklahoma		(40,000)		15,000		30,000		5,000
PAULA Insurance Company[2]		(115,000)		25,000		140,000		50,000
Republic Indemnity Insurance Company		(135,000)		30,000		220,000		115,000
Other Companies		(270,000)		93,000		258,000		81,000
TOTAL	**$**	**(1,400,000)**	**+**	**350,000**	**+**	**1,700,000**	**=**	**650,000**

[1]Fronted by American Re
[2]PAULA gave us lower estimates. It said that its underwriting gain was $25 million to $30 million.

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