The world's most dangerous insurance publication℠

SCHIFF'S INSURANCE OBSERVER

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The Right Time at the Wrong Place

A Fine Mess

"I don't drink liquor," quipped acerbic Oscar Levant. "I don't like it. It makes me feel good." When the insurance industry is in a cyclical upswing, the folks who run big insurance companies feel good. As their companies' results improve and stock prices rise, their paychecks grow and egos swell. Soon they've forgotten that in a cyclical industry nothing fails like success. Caution gives way to abandon, and risk is assumed without commensurate reward.

A friend once told Robert Benchley that drinking was a slow poison. "So who's in a hurry?" he replied.

Insurance is a slow poison. After too many years of downing cocktails in swank nightclubs, the insurance industry isn't feeling well. It wakes up each morning with bloodshot eyes and breath as hard as kerosene. The slow poison of prosperity has produced the hangover of austerity. In some cases, penury and insolvency will result.

The following exchange occurs in Hemingway's "The Sun Also Rises":

"How did you go bankrupt?" Bill asked.

"Two ways," Mike said. "Gradually and then suddenly."

We recall that bit of dialogue while pondering the fate of insurance companies, particularly troubled ones. The circumstances that lead to financial distress rarely happen overnight; they build up gradually. Beneath the surface and over time, pressure is created as assets and liabilities imperceptibly shift against each other, producing slips and fractures that—suddenly—create rifts of such magnitude that a financial earthquake occurs. The damage from this "sudden" economic dislocation isn't necessarily confined to the epicenter (the company at which it occurs). Instead, the shock waves can fan out, creating unanticipated losses elsewhere.

One who examines the rugged terrain of Insuranceville at the end of the 20th Century doesn't need to divine subsurface faults to have much to consider. Just as an intrepid meteorologist might ignore a drizzle in Missouri to focus on a tropical storm off the coast of Florida, the financial seismologist can, right now, take note of the tremors emanating from Conseco, Frontier, General American, Reliance, and Superior National—to name a handful of companies.

The question to ask is not, "Can these companies prosper?" but "Can these companies survive?"

Financial institutions, due to their inherent leverage, are uniquely prone to *gradual then sudden change.* (Only by employing leverage can most even hope

The world's worst theme restaurant

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to achieve above average returns.) But the leverage that creates higher returns comes at a cost.

In *Chaos*, James Gleick notes that "tiny differences in input [can] quickly become overwhelming differences in output....In weather, for example, this translates into what is only half-jokingly known as the Butterfly Effect—the notion that a butterfly stirring the air today in Peking can transform storm systems next month in New York."

An insurance company with $10 billion of assets and $9 billion of liabilities (a/k/a reserves) will have $1 billion of surplus. But if the assets are slightly overstated or the reserves are slightly understated—or some external event changes the relative values of the two—the likely result will be a disproportionately large effect on the company's surplus.

Suppose the company has 90% of its assets in bonds and 10% in stocks. A decline of 4% and 15%, respectively, will result in losses of $360 million and $150 million, reducing surplus to $490 million. Let's also say that the company's reserves are understated by two percent. That would lower surplus to $310 million. Now suppose the company is unable to collect $100 million of reinsurance recoverables. That leaves a mere $210 million in surplus. (Since this is a hypothetical company, we have set it in a tax-free environment.)

At the sold-out *Schiff's Insurance Conference* in September, every speaker commented on the capital markets. (We didn't ask them to; they just did.) Of course, the speakers were as savvy as they come, and it's difficult to be in the insurance business these days and *not* take notice of capital.

On one hand the industry is flush. Life-insurance company balance sheets appear robust (for now) and the property-casualty industry is loaded with capital. The result: too much surplus chasing too few dollars of premiums, which, while good for insurance buyers, means lower margins for insurance companies.

By most measures, the property-casualty industry is overcapitalized, even though many individual companies are undercapitalized. Certainly it has too much capital to allow for exceptional profitability (absent exceptional investment results).

Written premiums grew 2% in 1998, and the ratio of written premiums to surplus was 91%. History indicates that a low premium-to-surplus ratio results in slower growth in premiums, while a high premium-to-surplus ratio results in more rapid growth in premiums.

A high premium-to-surplus ratio is generally the result of a decline in surplus (due to underwriting or investment losses, or both). The losses cause fear, which creates a shortage of capacity, which drives rates higher, which means more premiums. (Customers don't have too many alternatives; insurance is a necessity.) The rapid increase in premiums produces profits, replenishing surplus.

Since capital markets are reasonably efficient, disintermediation takes place. If insurance is exceptionally profitable because of a shortage of capital—Voilà!—capital enters the business, creating competition and eventually reducing profitability.

Right now capital is plentiful and, as a result, rates are generally inadequate. Because insurance companies can't earn a compelling return on their capital, insurance stocks are severely out of favor. When the market closed on December 10, the stocks of 90 insurance companies in the SNL Securities database were trading below book value.

Some stocks are so cheap relative to book value that it seems as if the situation cannot endure for many years. At its recent price of 10¼, PXRE Corp., which writes catastrophe reinsurance, is selling for 40% of book value. (For the record, we're a shareholder.) At this price we can envision several scenarios: 1) the stock rises because it is so cheap; 2) someone—perhaps a financial buyer rather than a strategic buyer—attempts to take over the company; 3) PXRE pisses its capital away to such an extent that its stock is no longer cheap. (In other words, if the stock price doesn't rise to book value, book value may fall to the stock price.)

The third scenario isn't absurd. There are dozens of public insurance companies that have blown their capital, or are in the process of doing so. Insurance CEOs don't give up their positions willingly, and most prefer to acquire rather than be acquired. Nonetheless, when independent insurance companies trade at huge discounts to conservative estimates of their liquidating values, they stand a good chance of being taken over, whether they like it or not.

In the end, it doesn't matter if insurance companies lose their capital suddenly, gradually, or waste it on fancy headquarters, bad acquisitions, or overpriced share repurchases. When the industry's surplus is sufficiently depleted, premiums will rise faster than usual.

Insurance has a long history of cyclicity (see the chart on page 3), and investors know that the insurance industry cannot grow rapidly—much less profitably—for extended periods.

There is another industry that's similar to the insurance industry in some respects; its companies are not currently profitable yet they are awash in capital. That industry's companies, however, sport valuations that bear no known relationship to sales, earnings, assets, or book value. We're referring to the Internet industry.

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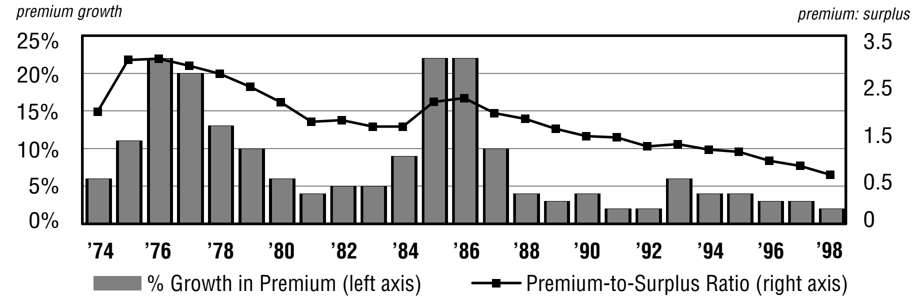
Percentage Growth in Premiums vs Premium-to-Surplus Ratio

Premiums have grown faster when the premium-to-surplus ratio is higher. The premium-to-surplus ratio tends to be highest when surplus is depressed.



Source: A.M. Best

Yahoo's market cap, for example, is equal to that of Marsh & McLennan, Allstate, Cigna, Hartford, Chubb, St. Paul, and Progressive *combined*.

AOL earned $184 million last quarter, and AIG earned $1.27 billion. (AOL's *revenues* are only slightly higher than AIG's *earnings*.) Yet AOL's market cap is greater than AIG's. And AIG is hardly a "cheap" stock; it trades at 35 times earnings and 5.3 times book value.

Unlike insurance investors, dot.com investors cannot look at history and conclude with certainty that dot.com companies will *not* take over the world. Whereas insurance stocks are weighed down by the past, dot.com stocks are levitated by the future. And to judge from their stock prices, the dot.coms' future is the stuff that dreams are made of. ("In the factory we make cosmetics," said Revlon's founder, Charles Revson. "In the drugstore we sell hope.")

Hope springs E-ternal right now. In the third quarter, InsWeb, the online insurance marketplace, lost $11 million on revenues of $7 million. Yet its market cap is $1 billion—ten times book value and 20 times next year's revenues. Earnings, by the way, aren't expected to materialize anytime soon.

InsWeb provides a useful service (see *Schiff's Insurance Observer*, March 1999, pp. 28-30), but is the company worth twice as much as insurance broker Brown & Brown, which should earn $25 million in 1999?

Somewhere in the world of high finance there's an arbitrage waiting to happen. Companies with rich valuations will realize it makes sense to use their stock as currency to buy insurance companies (note Berkshire Hathaway's acquisition of General Re). AOL, for instance, could buy Progressive for $230 per share (three times the going rate on the NYSE), yet would need to issue only 7.6% of its stock to do so. (Since AOL's p/e ratio is 254, versus 15 for Progressive, the deal would be accretive to earnings.)

We realize that Internet investors would be horrified, to say the least, if a dot.com company bought something as prosaic as an insurance company—unless a case could be made that the deal was rich with synergy. (Such a case can always be made, and we shall make it even though we don't really believe it. Each time you log on to AOL you will be greeted by a Progressive banner ad offering you a deal on your auto insurance. If 1,000,000 of AOL's rapidly growing horde of users switch to Progressive the first year, and 1,300,000 switch the second year…)

Even if the AOL deal doesn't materialize, there's always Yahoo!, Amazon, eBay, E*Trade, or Priceline ("Name Your Own Premium…and Save"). And if it's not one of these companies, then why not an even smaller highflier. Instead of offering all stock, perhaps it would offer a combination of stock, convertible debentures, warrants, PIK preferred, and zero-coupon bonds.

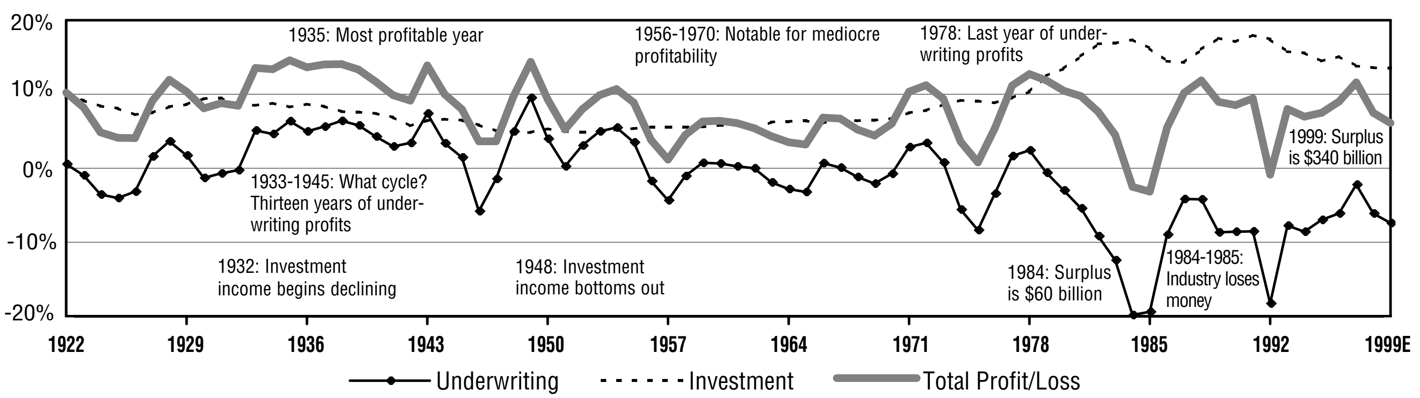
It sounds preposterous, but it's not unprecedented. Thirty-one years ago, a small, unseasoned computer-leasing company that had a hot stock issued a jumble of securities to take over a 150-year-old insurance company that was ten times its size.

But we'll save the story of Saul Steinberg's acquisition of Reliance for our next issue.

The Long-Term Property-Casualty Cycle: Results as a % of Written Premiums

Using the industry's combined ratio as a proxy for profitability has its limitations (but it's still instructive). In this century, casualty premiums have grown much faster than property premiums. Since casualty claims are paid out over a period of years, insurance companies can lose money underwriting but still earn a reasonable profit due to the time value of money. (They earn income on the money offsetting their reserves, as well as on their own capital.) As a result, investment income, not underwriting profits, has become a more important source of industry profitability.

The chart below is based on *calendar* year results, which aren't adjusted for subsequent changes in reserves.



Source: Standard & Poor's

A Shift in 'Core Competencies'

Allstate Changes Course by David Schiff

The following piece, which I wrote on July 14, appeared in the August 1999 issue of Insurance Investor, *published by SNL Securities. At that time Allstate's shares were trading at 35. At press time, they were at 27.*

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In Allstate's 1994 annual report, president Ed Liddy wrote that "focus" would "drive" Allstate's growth in the future: "We will build upon our core competencies. We will do what we do best."

In Allstate's 1998 annual report, Liddy espoused a different strategy: "We plan to build or buy capabilities that will make us a force beyond our traditional base. For us to achieve sustainable, profitable growth year-in and year-out, we must utilize additional channels, brands, and products. We must start reaching segments of the marketplace we don't currently reach…The Allstate Corporation will, over time, be multi-channel, multi-brand, multi-product, and multi-national."

In short, it will be *multi-core-competency*.

Why the change? It was becoming difficult for Allstate to extract growth from its core competencies. Standard auto premiums increased 2.6% in 1998, and non-standard increased 6%—not the stuff that incites portfolio managers to pay 20 times earnings.

Allstate's "problem" is that private-passenger auto has been too good for too long, and profitability is declining, or will decline. The reasons for this are inherent to the industry: competition, cyclicity, harsher regulatory environment, too many companies chasing too few drivers—take your pick, or, choose all of the above.

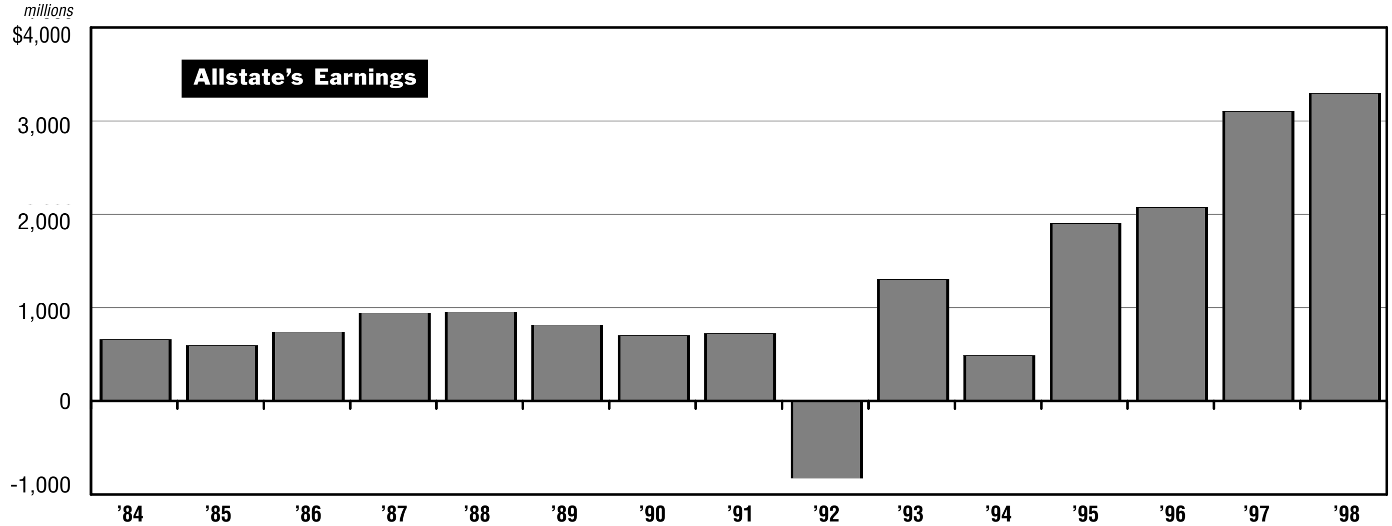
Allstate got used to thinking of itself as a *growth* company, and so did Wall Street. In December 1994, when I bought Allstate's shares at $12.03, I viewed Allstate as a cyclical company with a fine consumer franchise that, because of its exposure to massive (but low-frequency) earthquake and hurricane risk, was out of favor with investors. Allstate, which had been hurt by Hurricane Andrew in 1992 and by the Northridge quake in 1994, was then trading at six times the next 12 months' earnings and 127% of book—a price that implied a major catastrophe every few years. But it was reducing its catastrophe exposure, and earnings were about to take off, fueled by favorable auto experience. (Auto represents about 75% of Allstate's property-casualty premiums.)

Over the next four years, Allstate's earnings grew sevenfold and book value more than doubled. But good times don't last forever in the insurance business. Profits attract competition, competition creates pricing pressure, and pricing pressure reduces or eliminates profits. The pain caused by this process eventually drives competitors out of the market, creating an environment in which profitability returns. Then the cycle repeats itself.

By May 1998, many years of favorable auto experience had made me bearish on private passenger auto; I figured that at some point the tension between supply and demand would stamp out the fat profit margins. I wrote the following in *Schiff's Insurance Observer*: "Auto insurance—the largest property-casualty line based on premiums—is poised to enter a lean era marked by rate cutting, commission cutting, relentless competition, increased penetration by direct marketers and Internet sellers, and regulatory wrath…Although every insurance company has a stated goal of earning a 15% return on equity, insurance is not a 15% return-on-equity business. It is a cyclical business whose products are, for the most part, commodities." A few months later Allstate's stock topped out at $51.31. It now trades at $35.

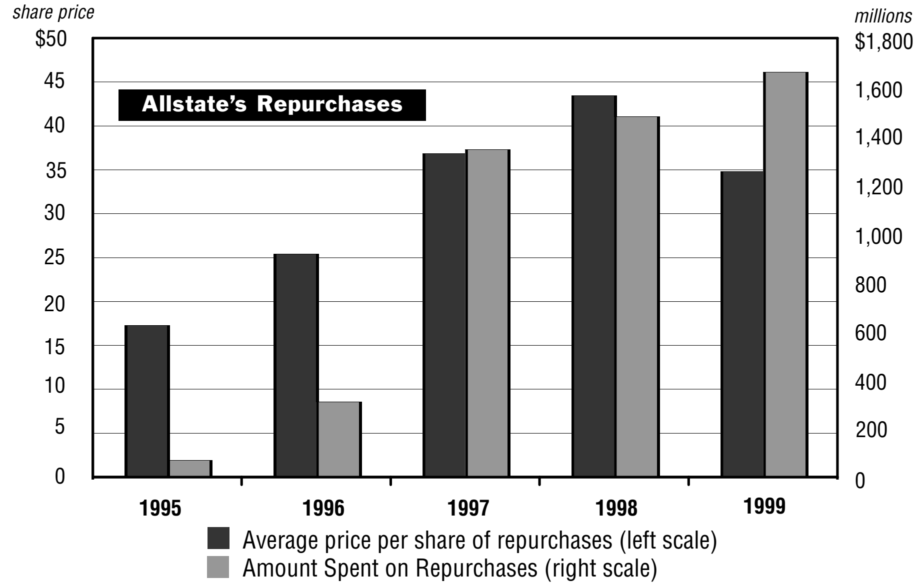
Behold the Insurance Cycle: Allstate's Earnings from 1984 to 1998

Allstate is a good company, but its results, like those of all insurance companies, tend to fluctuate considerably from year to year. To some extent, reported earnings are "smoothed" by reserve practices (sometimes reserves are too high; sometimes too low). From 1984 through 1998, Allstate's earnings averaged $1.164 billion per year.



Allstate Goes Wild Buying Its Own Shares

Allstate wasn't repurchasing its shares in late 1994 when they were really cheap, nor was it buying in much stock in 1995 or 1996. By 1997, however, it had caught buyback fever and began escalating its repurchases. In early 1997, *Schiff's*, noting that numerous insurance companies had suddenly got religion and were repurchasing their shares, wrote the following: "Does it build shareholder value to buy back stock at a price way above book value? We're skeptical. If the industry is overcapitalized, won't margins be pressured and earnings lowered? The demand for insurance, after all, is relatively stable. It's the supply that generally fluctuates."



Source: Dowling & Partners Securities, L.L.C.

In 1994 Allstate was coming out of a trough; now it's riding the crest of a wave. At 175% of book and 10.5 times next year's *consensus* earnings of $3.50, I'm unenthused. And if I'm correct about the prospects for the auto-insurance business, Allstate's future earnings may be less than expected. [Allstate subsequently reported weak earnings, and securities analysts lowered their estimates for the company.]

I still own some of the Allstate I bought five years ago (it's in a taxable account), but I'm not buying more; the risk-reward ratio doesn't seem attractive at these prices. Expanding beyond the "old" core competencies entails risks: Allstate will be selling through independent agents under the CNA moniker—a strategy unlikely to please Allstate's exclusive agents. And buying American Heritage Life for $1.1 billion (three times book) is not my cup of tea.

The new strategy may work, but it doesn't hold much appeal for an old-fashioned value investor like me. Allstate's core business is good, but cyclical. But who's to say that the CNA and American Heritage acquisitions will work out? And can Allstate really achieve "sustainable, profitable growth year-in and year-out?" Indeed, if it can do this in the future, why didn't it do this in the past?

I recently bought shares in nine decent—but out of favor—insurance companies with respectable balance sheets. They've all got some problems—which is why momentum investors don't like them—but that's why they're so cheap. I've generally found that buying decent, conservatively managed insurance companies at a nice discount to book is a pretty good way to make money.

As for Allstate, it's a "buy"—but in the $20s.

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By early October, Allstate's shares had taken a tumble. When they hit $23½, I bought.

I'm still bearish on auto insurance, however. The forces of direct marketing, the Internet, overcapitalization, as well as a resurgence in inflation, are likely to wreak havoc in the private-passenger auto insurance industry.

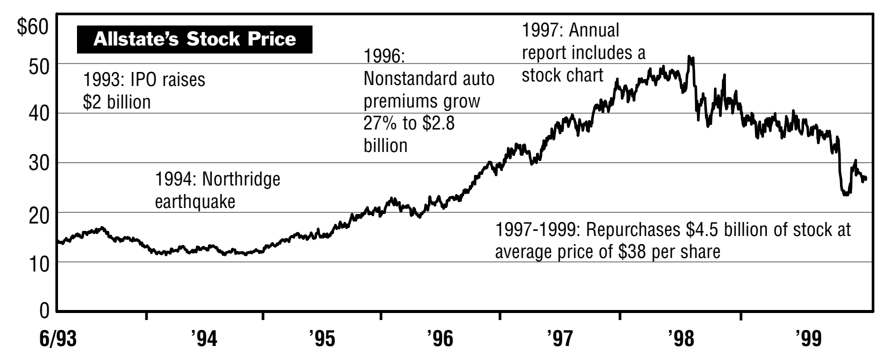
Analysts now expect Allstate to earn about $2.70 per share this year, and a bit more next year. I think the analysts are overly optimistic, and wouldn't be surprised if Allstate's earnings stagnated, or declined, for a number of years. Nonetheless, in the low 20s, Allstate's shares represent a good value—assuming that the company doesn't blow its capital on pricey acquisitions.

Allstate Has Its Hands Full

Sometimes a stock chart says a lot. Allstate went public in June 1993 at 13¾. Seven months later the Northridge earthquake shook California, and Allstate's shareholders. Allstate's auto-insurance business was improving dramatically, however, and its non-standard auto business was growing rapidly.

The stock market eventually noticed the improving results, and Allstate took notice of the market—perhaps too much notice. Its 1997 annual report included a stock chart for the first time.

Although its stock had tripled in three years, Allstate began a huge repurchase program. Between 1997 and 1999 it spent $4.5 billion to buy back 118 million shares at an average price of 38. By 1999, Allstate's growth had slowed, its combined ratio had risen sharply, and competition had intensified.



Source: SNL Securities LC

A World Full of Opportunity

General American's Debacle

In early June, 3,000 people attended the Insurance Accounting and Systems Association's annual shindig, held this year in San Diego. Although the convention lasted four days and included more than "110 technical sessions," the highlight was a "Super Session," Growing Capital the Old Fashioned Way.

Before an audience of perhaps 1,000, two men shared their differing opinions about the insurance industry.

One speaker was E. Thomas Hughes, Corporate Actuary and Treasurer at GenAmerica Corporation. (GenAmerica owns General American Life Insurance Company and is the stock subsidiary of General American Mutual Holding Company.) According to the June 14 edition of Insurance Accounting, *Hughes was an "expert," which may be why the publication devoted all but the last paragraph of its article on the Super Session to his comments.*

Hughes painted a pleasing picture of the future: he spoke of an insurance world filled with opportunities—opportunities in international expansion, consolidation, cross-selling, asset accumulation, convergence, and financial services. GenAmerica, which was planning an IPO the following year, was poised to take advantage of these opportunities, Hughes said.

The other speaker was a bit of a sourpuss. He talked about risk, competition, commodity products, and speculation. He emphasized the importance of financial strength, said that consolidation doesn't necessarily work, and gave a brief history of large insurance companies that had failed. Exuberant markets had created a sense of unreality, declared the speaker, an insurance observer named David Schiff, described as an "industry gadfly" by Insurance Accounting.

Two months later, General American—the company poised to seize a world full of opportunities—was unable to meet its financial obligations and was placed under the administrative supervision of the Missouri Department of Insurance. The following month General American Mutual Holding Company was placed into "rehabilitation," which in this case meant its liquidation after the sale of GenAmerica to MetLife for $1.2 billion. Whatever is left after expenses and contingent liabilities have been paid will be distributed to General American's mutual holding company members within three years.

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You never know who's swimming naked until the tide goes out.

Until early this summer, General American Life Insurance Company was widely perceived as an old conservative, Midwestern insurer. It was formed in 1933 (to take over insolvent Missouri State Life) and headquartered in St. Louis. In fact, it wasn't conservative—it had become an aggressive financial operator, accumulating so much risk that it unwittingly bet the company on a dangerous investment concept: borrowing short and lending long.

General American's failure stems from its issuance of "funding agreements," a product that has absolutely nothing to do with life insurance. General American had become a major issuer of funding agreements, and by July had $6.8 billion worth outstanding. (They were held by 37 institutional investors, primarily money market funds).

On July 30, in response to severe financial problems at Integrity Life (which reinsured half of General American's funding agreements), Moody's lowered General American's rating from A2 to A3. This prompted most of General American's funding-agreement holders to ask for their money back in accordance with contractual provisions.

By August 7, General American realized that it couldn't redeem its funding agreements without jeopardizing its ability to meet its policyholder

obligations. On August 10, General American sought relief from the Missouri Department of Insurance, which placed it under "administrative supervision"—in this case the equivalent of Chapter 11.

Six business days after having been downgraded (deservedly) by Moody's, General American had become the largest failure in the history of the U.S. life insurance business.

Like the devil, funding agreements are referred to by many names. "Guaranteed interest contracts," "asset accumulation products," "stable-value products," and "spread-based products" are popular variations. Regardless of the name, a funding agreement isn't particularly complicated; it's simply a form of short-term debt issued by an insurance company.

When an insurance company issues a funding agreement, it's borrowing money. When a money-market fund buys a funding agreement, it's lending money to an insurance company. (Guaranteed Investment Contracts [GICs] and annuities are, essentially, borrowed money, too.)

Unlike long-term GICs—which damaged Equitable and helped sink Executive Life—funding agreements have attributes similar to commercial paper, and are short-term obligations. An issuer of funding agreements generally expects them to be rolled over or kept in force for longer periods.

Funding agreements are general account liabilities, which means that they're backed by the full faith and credit of the issuing insurance company and rank equally with policyholder liabilities (i.e., life-insurance reserves). While this may be acceptable from a regulatory point of view, the accounting treatment accorded funding agreements (and GICs) is troubling. Although they are short-term debt, funding agreements don't show up as such on an insurance company's consolidated balance sheet. (GenAmerica, for example, carried its funding agreements under the header "Policy and Contract Liabilities.")

We believe that insurance companies should classify funding agreements as short-term debt, and GICs as long-term debt. Had GenAmerica done so, it would have reported $13.7 billion of "policy and contract liabilities" and $6.8 billion of short-term debt rather than $20.5 billion of "policy and contract liabilities." (We'll discuss GenAmerica's financials in more detail below.)

Prior to General American's debacle, funding agreements had become a popular investment for money-market funds. (Moody's estimated that the size of the market was $50 billion.) Because money-market funds need paper that won't "break the buck," funding agreements generally contain a feature permitting holders to "put" the funding agreements back to the insurance company at par. Most insurers limited this put to 30 days' notice, but General American, which was unusually aggressive, issued funding agreements with seven-day puts.

In addition to their apparent liquidity and "stable value" characteristics, funding agreements appealed to money-market funds for at least two other reasons: they were considered to be high quality assets and, more importantly, they paid higher rates of interest than most other money-market instruments. According to a Moody's report issued earlier this year, funding agreements yielded 2 to 20 basis points more than high-quality commercial paper with similar maturity characteristics. (*The Insurance Forum* reported that a General American "Funding Agreement for Institutional Markets Form No. FRFA-395" on file with the Missouri Department of Insurance paid the one-month London Interbank Offered Rate [LIBOR] plus 20 basis points.)

Although borrowing short-term money at 20 basis points over LIBOR might be attractive, it only makes sense if one has a suitable use of proceeds. General American, however, didn't have short-term capital needs. Instead, it viewed funding agreements as a "spread" business in which it would relend the borrowed funds at a higher rate.

But how could General American—or any company—make money on the money it borrowed if it was paying *more* than other high-quality credits were paying? (If General American bought commercial paper that paid the LIBOR rate, it would *lose* 20 basis points plus expenses.)

General American had several alternatives: 1) it could invest its short-term borrowed funds in higher yielding—but lower-quality—paper; 2) it could take advantage of an upwards-sloped yield curve and buy longer-term (thus higher-yielding) paper; or 3) it could buy longer-term, lower-quality paper.

It appears that General American did all three.

In August we asked the company if it had matched its funding-agreement liabilities with assets that had similar terms and characteristics; we were told that the answer to this was proprietary. General American's inability to meet its obligations, however, demonstrated that the answer wasn't proprietary: the company's assets and liabilities were horribly mismatched.

How much had General American stood to earn on the $6.8 billion of funding agreements it had outstanding? If it made a 50 basis-point spread it would earn $34 million. If it made 10 basis points, it would earn $6.8 million. (Why would anyone risk $6.8 billion to make $6.8 million?)

Because General American was unable to perceive the risk in what it was doing, it—in a sense—used its capital twice: once to support its insurance business, and once to support its funding-agreement business. At December 31, 1998, GenAmerica had $29 billion of assets, $27.7 billion of liabilities, and $1.3 billion of stockholder equity. This sliver of equity was terribly inadequate to support an insurance business *and* a large funding-agreement business.

Suppose that GenAmerica was prepared, in theory, to commit $200 million to its funding-agreement business. Then, based on $6.8 billion of funding agreements outstanding, its capital would be leveraged 35-to-1 ($0.2 billion + $6.8 billion = $7 billion). Of course, General American's risk was not limited to $200 million.

Compounding the company's investment risk was the fact that its 37 funding-agreement holders all had similar objectives and terms. Under a variety of reasonable scenarios, virtually all holders would ask for their money back at the same time, which is exactly what happened.

An examination of GenAmerica's 1998 consolidated balance sheet is revealing—and sobering. The company had total assets of $29 billion, only a portion of which was available to repay the $6.8 billion of funding agreements.

From $29 billion, one must subtract

Funding Agreements are Debt, not Insurance Liabilities

The figures on the left summarize GenAmerica's presentation of its consolidated balance sheet as of December 31, 1998. The figures on the right are our restated version, treating the company's $6.8 billion of funding agreements as short-term debt. At the bottom of each column we've added a calculation: "debt as a % of equity." Note the difference.

all figures in thousands of dollars	GenAmerica	GenAmerica (Restated)
Assets		
Investments	$16,546,057	$16,546,057
Cash	619,494	619,494
Other Assets and Deposits	5,719,887	5,719,887
Deferred Policy Acquisition Costs	776,261	776,261
Separate Account Assets	5,287,456	5,287,456
Total Assets	$28,949,155	$28,949,155
Liabilities		
Total policy and contract liabilities	$20,486,439	$13,686,439
Short-Term Debt (Funding Agreements)	-	6,800,000
Long-Term Debt	216,318	341,318
Other Liabilities	1,169,757	1,169,757
Separate Account Liabilities	5,267,553	5,267,553
Total Liabilities	$27,140,067	$27,265,067
Minority Interests	383,900	383,900
Redeemable Capital Securities	125,000	-
Stockholder Equity	$1,300,188	$1,300,188
Debt as a % of Equity	***26%***	***549%***

$5.3 billion of separate account assets, $2.1 billion of policy loans, and $800 million of deferred policy acquisition costs. That leaves $20.8 billion in assets, from which we'll subtract "other assets" of $631 million. The result is $20.2 billion.

Thus, General American's funding-agreement liabilities were equal to a shocking 34% of GenAmerica's investment assets.

The closer one looks, the worse it gets. Of GenAmerica's $11.2 billion in fixed maturities, corporate securities comprised $7.2 billion and mortgage-backed securities comprised $1.8 billion. The company also had $2.3 billion in mortgage loans, $785 million in reinsurance recoverables, and $4 billion of other contract deposits. Obviously, these are not as liquid as short-term Treasurys. (If GenAmerica had opted for safety and liquidity, it couldn't have made a positive interest-rate spread.)

In order to make a positive spread, the company played the yield curve and the credit curve. Seventy percent of its fixed-income investments mature between 2003 and 2018.

General American's funding agreement strategy (borrowing short and lending long, and lending to lower-quality issuers) works well under certain circumstances. But if short-term and long-term interest rates are rising—as they were throughout 1999—it becomes disastrous. (When rates rise, longer-term securities decline more than shorter-term securities.) The strategy also fares poorly when the spreads between high-quality and low-quality paper widen.

Think of General American's funding agreements as a hedge fund that was short $6.8 billion of seven-day paper and long a mixture of intermediate term fixed-income securities of varying quality. A small rise in interest rates would have a negligible impact on the value of the seven-day paper but could easily cause a 5% decline ($340 million) in the other securities.

As the markets moved against General American, its securities became worth significantly less than their carrying value. Yet its liabilities—"the stable-value" funding agreements—remained the same. The company's problems were greatly exacerbated by its relationship with ARM Financial (an asset accumulation business) and its subsidiary, Integrity Life.

Since Integrity didn't have high enough ratings to sell funding agreements to most institutional investors, it had a deal in which higher-rated General American acted as a "front" and issued the funding agreements on its paper. General American then reinsured half the business—$3.4 billion—with Integrity. The assets backing Integrity's half of the business were held in a trust (whose assets were invested more aggressively than General American's.)

By July, ARM and Integrity were in serious financial trouble. Effective July 26, General American ended its relationship with ARM and recaptured the assets in the Integrity trust. (For more on this, see page 10.)

General American had $6.8 billion of funding agreements outstanding, yet was unable to raise even $4.5 billion when it needed to.

In a memo written three weeks later, General American's chairman, president, and CEO Richard Liddy said that in recapturing the assets in the Integrity trust, General American's "intent, as articulated to the rating agencies, was to decrease the amount of [the funding agreement] business in an orderly manner."

It appears, however, that General American's *primary* motive in recapturing the trust's assets was to avoid becoming one of Integrity's creditors in the event that Integrity was seized by the Ohio Department of Insurance. As a creditor, General American would have a claim subordinate to that of Integrity's policyholders. (On August 20, Integrity was placed under regulatory supervision after the Ohio insurance commissioner decided that the company was "in such condition as to render the continuance of its business hazardous to its subscribers, certificate holders, or to the public.")

On Friday July 30, Moody's, whose view of General American was much less favorable than that of Best and Standard & Poor's, downgraded the company from A2 to A3. Almost immediately, institutional investors asked for their money back.

Within four days, General American needed $4.4 billion to repay the funding-agreement holders that had exercised their put options. (Many money-market funds will not hold paper with an A3 rating.) According to Liddy's memo, General American had "$2.5 billion of ready liquidity." Raising an additional $2 billion, he wrote, "would have been difficult but possible in a normal investment environment. Unfortunately, during the week all this occurred, investment markets were anything but normal. As the week unfolded, a combination of economic factors and public statements caused bond markets to become very unsettled. This created a difficult environment in which to sell bonds, especially at prices that made sense…To meet payment demands would have led to tremendous capital losses. Even if asset sales could have been accomplished, it would have dramatically reduced General American Life's capitalization and dramatically reduced the economic value available to all our policyholders."

Liddy's statement is a testament to General American's inappropriate investment strategy and asset-liability strategy. Although his company had $6.8 billion of funding agreements outstanding, it was unable to raise even $4.5 billion when it needed to. Insurance companies are supposed to be able to withstand situations that aren't "normal." Besides, the investment environment wasn't really unusual: it's normal for markets to fluctuate, sometimes sharply. (Other than General American and Integrity, no major insurance companies were placed under regulatory supervision as a result of the bond market's behavior during early August.)

General American's difficulties weren't unforeseen. In December 1998—almost eight months before General American was taken over by the regulators—Moody's had placed the company's A1 rating on review for a possible downgrade. "We are concerned about General American's exposure to these [funding agreement] liabilities, which are highly credit- and market-sensitive," wrote Moody's. "In the event of a rating downgrade or capital market disturbance, General American, as the direct writer, would be the first in line to fund surrenders, and is exposed to substantial business and liquidity risk." On March 5, after completing its review, Moody's downgraded General American from A1 to A2, citing, among other factors, the company's "significant exposure to funding agreements with short-term put options."

On August 9, General American deferred payments due to the holders of its funding agreements. Moody's downgraded the company four more notches, to Ba1.

On August 10, General American was placed under the administrative supervision of the Missouri Department of Insurance. Standard & Poor's lowered General American's rating from AA- to BBB-. Later that day it downgraded it to R (regulatory action regarding solvency). Duff & Phelps lowered General American's rating from AA to DD.

On August 11, A. M. Best downgraded General American from A+ to B. Randy McConnell, a spokesman for the Missouri Department of Insurance, apparently wanted to place the blame for the General American debacle as far from Missouri as possible. The insurance department had "no red flags" prior to General American's failure, he said. "Mismatches of investment and cash demands, particularly when these demands are triggered by a third party [he was referring to Moody's] who you have no control over, are difficult to predict."

On August 12, as the situation worsened, Moody's downgraded General American from Ba1 to B1.

At that moment, even though General American's had an estimated $400 million of unrealized losses, its official stance was that it was suffering from a "short-term liquidity problem."

Liddy, who as chairman, president, and CEO, must have been aware of his company's concentration of risk and Moody's negative stance on the funding-agreement business, didn't want to be held responsible for the fiasco that was unfolding. When *The St. Louis Post-Dispatch* asked him what he thought of Moody's, he replied, "You run a family newspaper, don't you? I don't think you can quote me on that question."

Later, Liddy told the *Post-Dispatch* that he was partly to blame: "The thing we can be faulted for is this: how did we ever get in a position to let Moody's make us this vulnerable?"

General American got into that position because Liddy and the other directors didn't know what they were doing. They allowed inappropriate, leveraged investments to dominate their company's balance sheet. No insurance company should take on an excessive concentration of risk. Doing so violates the fundamental insurance principle of *spreading* risk.

That General American would do so was not surprising. It was the second mutual life insurer to form a mutual insurance holding company, and had used that structure to take on a bit more leverage than it might have been able to take on as a mutual. (That sort of "financial flexibility" has been touted by mutual-insurance-holding-company proponents as one of the advantages of the structure.)

In the end, it was the mutual policyholders, who owned General American, who were the big losers. A significant amount of their equity value was wiped out.

Although General American's business strategy was reckless and misguided, much of the public comment on the matter has missed the point. Many are viewing the debacle as one-of-a-kind situation—some quirk exacerbated by weird circumstances.

While other companies may not be taking the same risks that General American took, some are taking risks that aren't prudent. Of course, outsized risks aren't usually apparent to the people taking them, or they wouldn't be taking the risks.

Insurance companies are inherently leveraged. Small miscalculations—whether in underwriting, investing, or loss reserving—can be magnified over years, especially when the conditions that create the miscalculation aren't recognized.

Leverage, time, and distance amplify mistakes. If, for example, you're heading towards your front door and are 1° off course, you're still going to make it to the door. If you're heading towards Jupiter and are off by 1°, you're in trouble.

In December, ARM Financial announced that it was selling its insurance subsidiaries and filing for bankruptcy.

Richard Liddy is still chairman, president, and CEO of General American.

A Dubious Nondisclosure

General American Life controls 64% of publicly-traded Reinsurance Group of America (RGA). On August 25, RGA filed a Form 8-K with the SEC. An 8-K requires a registrant to disclose any proceeding under state law in which a government agency has assumed jurisdiction over the business of the registrant's parent by leaving its existing directors and officers in their positions, albeit subject to the supervision and orders of the government agency.

RGA's 8-K said the following:

> On August 10, 1999, General American Life Insurance Company ("General American") became subject to an order of administrative supervision from the Missouri Department of Insurance…
>
> Administrative supervision…requires General American to seek approval of the Department for major decisions or actions that are outside the ordinary course of business. The Director of the Division of Financial Regulation of the Missouri Department of Insurance has been named Administrative Supervisor of General American.
>
> [RGA] *has been informed that the order of administrative supervision is confidential*, and is filing this report on the assumption that disclosure may be required under Item 3(a) of Form 8-K. [RGA] *does not have sufficient information to express an opinion as to whether the Department has assumed jurisdiction over the business of General American*." [Emphasis added.]

Although the order of administrative supervision for General American was "confidential" in that it wasn't disclosed to the public, it's hard to understand how RGA could claim that it did "not have sufficient information to express an opinion as to whether the Department has assumed jurisdiction over the business of General American." After all, Richard Liddy who was chairman of RGA, was also chairman of General American. If he didn't know what the order of supervision contained, then who did?

SCHIFF'S
INSURANCE OBSERVER
Evening Telegraph Edition
September 2, 1999 Volume 11e • Number 1

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 was 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 would translate 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 differences 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," they're not unsaleable. The price at which these securities could be sold, however, was considerably lower than the price that General American wanted —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 loath 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 us 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 had been 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 acting opportunistically and trying to pick up some troubled merchandise at a good price. ■

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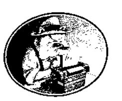

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SCHIFF'S
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Evening Telegraph Edition

November 15, 1999 — Volume 11e • Number 6

John Hancock's Unfair Demutualization Plan

Deceptive, Misleading and Coercive

Morgan Stanley Says Plan is "Fair"

Wit Capital Says Plan is "Unfair"

The Big Heat: Wit Capital Caves In

JOHN HANCOCK MUTUAL Life Insurance Company's demutualization is a milestone in the history of American mutual insurance. In 1998 Hancock threw in the towel on the now-discredited mutual-insurance-holding-company approach it had supported and announced that it would do a full demutualization, instead.

Sadly, Hancock's demutualization plan is structured in a manner that's unfair to the company's policyholder-owners. Some 2.1 million policyholders—including many large policyholders—who would have received about $1,500 of stock or less, will be *cashed out without their informed consent*. Hancock, which is not in need of additional equity, plans to do a $2 billion IPO. (The lead underwriter will be Morgan Stanley.) Most of the proceeds from the IPO will be used to cash out unwitting policyholders. If this plan is approved by the Massachusetts Division of Insurance and Hancock goes forward with its IPO as planned, institutional investors will, in all likelihood, get to buy Hancock shares at a significant discount to the company's intrinsic value. Meanwhile, 80% of policyholders will be cashed out in a manner that has negative tax consequences for them.

A public hearing regarding Hancock's plan will take place on November 17 and 18, in Boston. David Schiff, who opposes the plan, will be appearing as an "expert witness." Schiff, as always, will be testifying *pro bono*: he does not accept any fees, compensation, remuneration, or reimbursement of expenses. To read his November 8 pre-filed testimony in full, as well as that of former Vermont commissioner James Hunt, and senior officers of Wit Capital, go to www.HancockWatch.com., a website created by Adkins & Kelston, a law firm representing policyholders who are intervening in the proceedings.

Complex Plan

Like most demutualizations, Hancock's plan is extremely complicated and requires a significant base of knowledge and commitment of time to be fully understood. Given that it's so difficult for policyholders (and agents) to understand the plan, one would think that Hancock's directors, who have a fiduciary responsibility, would want to ensure that policyholders are able to comprehend what is happening. This could be accomplished by clear communication. The model we admire is that used by Warren Buffett in Berkshire Hathaway's annual letter to shareholders. (He has said that his letter is written so that it could be understood by an aunt who has been away traveling all year.) Hancock hasn't come close to this standard. Instead, its communication seems designed to take advantage of an aunt who's been away all year.

Hancock sent policyholders a seven-page glossy brochure that misinformed them of what their "membership rights" in the mutual insurer entail. By leading policyholders to believe that their rights are negligible, Hancock is coercing its policyholders to vote for a plan that is not in their best interests.

In addition to the glossy brochure, policyholders received a 317-page densely-worded "Policyholder Information Statement" (PIS) that omitted material disclosures and important information necessary to make an informed decision.

Included at the back of the PIS was a five-page Morgan Stanley "fairness opinion" signed by Derek Kirkland, managing director and co-head of Morgan's global insurance group. The fairness opinion, however, is window dressing: its abstruse verbiage contains so many caveats that the "opinion" is really no opinion at all.

Kirkland and Morgan Stanley also have material conflicts of interest (some of which were not disclosed to policyholders) that render them unfit to issue a fairness opinion in connection with the plan. Morgan Stanley was John Hancock's advisor in formulating the demutualization plan and, more importantly, will be the lead underwriter in Hancock's $2 billion initial public offering (which should generate about $100 million in fees for the underwriters). Morgan Stanley's substantial financial interest in seeing the plan approved creates an unconscionable conflict of interest that shouldn't be tolerated by the Massachusetts Division of Insurance. (Goldman Sachs had a similar conflict of interest in Principal Mutual's reorganization, and its opinion was subsequently thrown out by Terri Vaughan, Iowa's insurance commissioner.)

Incredibly, Derek Kirkland and Morgan Stanley had a conflict of interest in Provident Mutual's attempted mutual-holding-company conversion that is strikingly similar to their conflict of interest in the John Hancock matter. (Excerpts from David Schiff's cross-examination of Kirkland at the Provident hearing can be found on page 17 of the May 1998 issue of *Schiff's Insurance Observer*.)

Kirkland obviously knows a thing or two about insurance, and certainly holds himself out as an expert. And yet, at the Provident hearing, when given easy questions, his answers were simply amazing.

"Do you have an opinion," Schiff asked, "about what Provident Mutual is worth?"

"No," Kirkland replied. "We have not evaluated what Provident Mutual will be worth."

Although Kirkland had already testified that Morgan Stanley was "continually involved in the valuation of securities" in connection with "public offer-

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Reliance Group's Troubled Debt

Bonds Plunge

Prices Imply Default

PRICES FOR RELIANCE Group Holdings' publicly traded bonds have fallen sharply in the last few weeks and are now trading at levels that imply a significant risk of default.

On August 24, both the 9% Senior Notes due on November 15, 2000 and the 9¾% Senior Subordinated Notes due on November 15, 2003 closed at 99½. By September 14 they had collapsed to 95⅛ and 89⅛ , respectively.

At current prices, the yields to maturity for these issues are 13.62% and 13.21%—about 750 to 800 basis points above the yields for Treasurys.

Although markets aren't reservoirs of wisdom, the pricing in bond markets tends to be more meaningful than the pricing in equity markets. The yields on most "A" rated bonds, for example, will be similar. In general, the bond market displays rational behavior that is easily quantifiable: lower-rated bonds yield more than higher-rated bonds.

The stock market isn't so rational. Internet stocks, for example, aren't priced based on credit quality or earnings, but on vague perceptions of the future. The insurance business isn't especially rational, either. Customers generally don't demand a lower price from a lower-rated company, provided that the company in question has what is perceived as the requisite rating to compete in its line of business (often an A- from Best).

Given that markets are irrational—particularly over the short term—one must ask whether the price of Reliance's bonds is telling us anything of importance. Specifically, does the 13.21% yield to maturity on Reliance's debentures mean anything?

We believe it does.

First, it means that buyers of corporate debt aren't inclined—right now—to own Reliance's debt, despite the fact that it carries a staggeringly high yield. The 13.21% yield to maturity implies that bond buyers have serious doubts about Reliance's ability to repay its debt in full, when due. As a result, they want a very high yield to compensate them for the greater risk of default.

Although Reliance's bonds are trading at distressed levels, Reliance's stock is at 4½. Although this is down about 80% from its high, Reliance Group nonetheless still has a market cap of $516 million. It's axiomatic that if Reliance Group's $710 million of debt isn't worth 100 cents on the dollar, then its common stock is just about worthless.

And yet, the price of Reliance Group's common stock says that not only are the company's bonds money good, but there's at least $516 million left over for shareholders.

The bonds' prices, on the other hand, say that there's a significant risk that the bonds aren't money good (and therefore the stock has little value).

As for the insurance market, it doesn't post its opinion of the New York Stock Exchange every day. And, in any event, it's most concerned with Reliance Insurance *Company*, Reliance Group's main operating subsidiary.

Because of its financial structure, lower ratings, heavy dependence on commercial business, reserve problems, diminished financial flexibility, and involvement in Unicover, Reliance Insurance Company deserves a "vulnerable" credit rating—at least until it has refinanced or raised a significant amount of capital. Unless commercial-insurance buyers are getting significantly lower prices or significantly better coverage, they have little (if anything) to gain and much to lose by doing business with Reliance Insurance Company as it's presently structured.

As for Reliance Group's stock and debt, we're not buying either. If we had to buy one or the other, however, it would be the bonds. Even if one *loved* the stock at these prices, one would have to have a great deal of certainty about its value to forgo the 13.21% yield on the 9¾s of '03, which, by definition, carry much less risk.

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The Reliance Shuffle

Dividend Cut?
Meet the Enemy

RELIANCE GROUP HOLDINGS IS in a bind, and it's going to need some fancy maneuvering to get out of it.

In the August issue of *Schiff's Insurance Observer* we explained why Reliance, which is in dubious financial condition, was extremely vulnerable to a rating-agency downgrade. In September, in this publication, we noted that Reliance's stock, then 4½ (down from 19⅛), gave the company a market cap of $516 million—yet Reliance's bonds were under water and trading at a 13.5% yield to maturity.

The situation at Reliance has worsened. The stock market—admittedly, a suspect short-term indicator—has marked Reliance's stock down more (it hit an all-time low of 3¼ on Thursday before rebounding to 4 on Friday). The bond market, which tends to be more rational, is less optimistic: it's saying that Reliance's stock is essentially worthless. Reliance Group's 9¾% Senior Subordinated Notes due November 15, 2003 closed at 80¼, giving them a 17.7% yield to maturity—a 1,100 basis-point spread over Treasurys, and a price that implies insolvency.

Since the bonds are senior to the stock (but subordinate to policyholder obligations), we question whether anyone should purchase Reliance's stock rather than its bonds. If Reliance Insurance Company doesn't fail and Reliance Group makes good on its debts, one would almost double one's money on the bonds. (In theory, if Reliance's business is worth $710 million, the bonds would be money good while the stock would be worth nothing). Even if Reliance Group is solvent, the stock would have to double over the next four years to equal the returns available from the bonds. Although Reliance Group pays a fancy 32¢ per share dividend on its stock, it can ill afford the $37-million annual cash outflow this entails. Companies that are strapped for cash tend to cut their dividends. Reliance, of course, would prefer not to cut its dividend—for at least two reasons: 1) Steinberg's family receives $16 million a year in dividends, and 2) cutting the dividend would be an admission that the company is in weak shape.

For Reliance to continue its dividend it must either borrow money, issue securities, or (as has been the case in the past), upstream payments from struggling Reliance Insurance Company. As a result, Reliance Group's dividend cannot be considered secure, and there's a good likelihood that it will be reduced or eliminated.

As for Reliance's bonds, Steinberg doesn't have the option of reducing their interest payments.

Conditions at Reliance have become so precarious that A. M. Best, which very much does *not* want to pull the plug on the company, has finally taken action. On October 21 it gave Reliance a written tongue lashing: it placed the company's A- rating "under review with negative implications."

In its brief commentary, Best couldn't help but note what has been evident for quite a while: that Reliance Group will have to refinance over $500 million of holding-company debt next year ($230 million of which matures at the end of the first quarter); that Reliance is exposed to significant financial risk as a result of its Unicover fronting deals; that Reliance's surplus has declined due to operating losses and "unrealized losses on its sizable stock portfolio"; that "Reliance's financial flexibility has deteriorated further"; that Reliance will have to try to raise additional capital; and that "capital market conditions have worsened."

Despite this bounty of negatives, Best maintained Reliance's "A-(Excellent)" rating. According to Best, this reflects the company's "commitment to improving surplus levels … and refinancing its senior and bank debt in a timely manner." Best also said it expects Reliance to "exhibit stronger underwriting results next year as its commercial specialty businesses resume their historical profit trends." (We haven't noticed any historical profit *trends* at Reliance, and we don't anticipate improved industry results next year.)

Finally, Best said it expects to complete its review of Reliance during the first quarter (by which time it should be clear whether Reliance has refinanced and raised capital). Unfortunately, Best's time frame is of little use to insureds who would like a more discerning opinion of Reliance's current financial condition.

We've said this before and we'll say it again: if an insurance company is hanging on to the ropes and has to raise a big wad of capital in order to *maintain* its A- rating, then it stands to reason that it doesn't deserve an A- rating before it raises the capital. (According to Best, companies with an A- rating have "excellent financial strength, operating performance, and market profile," as well as "a strong ability to meet their ongoing obligations to policyholders.")

It Looks like Rain

It's an irony of finance that it is generally easiest to raise capital when one doesn't need it. As Samuel Insull, the Roaring Twenties' financier whose leveraged utilities holding empire subsequently collapsed, once noted, "Bankers will lend you umbrellas only when it doesn't look like rain."

For more than three decades, Saul Steinberg, the financial conjurer who controls Reliance, has been adept at borrowing umbrellas—and convincing people to give him their umbrellas. Steinberg has issued securities, made acquisitions for overvalued paper, done exchange offers, refinanced debt, juggled assets, used innovative accounting, and, often against long odds, managed to keep his leveraged insurance empire propped up so that he could get a

$9,000,000 salary last year. (His brother Robert got a little less.)

Right now, however, Steinberg reminds us of the L'il Abner cartoon character Joe Btsfplk, who always had a rain cloud over his head. Reliance Group is dangerously overleveraged, its ratings are precarious, its debt is coming due, and insurance pricing is as soft as putty. Exacerbating matters, the end-of-the-year renewal environment should be especially difficult for Reliance. It will have a tougher time retaining good business and getting price increases than stronger insurers will. (We don't think an insured should purchase a policy issued by Reliance Insurance Company if reasonable alternatives are available from more prudently capitalized companies).

As usual, Steinberg has something up his sleeve: he thinks the stock market hasn't "fully recognized" the value of Reliance's surety and fidelity operations, so Reliance has formed Reliance Surety Group, Inc., a holding company that will operate the surety and fidelity business. Reliance Surety plans to sell up to 20% of its common stock in an IPO. Potential buyers of this IPO would be wise remember that Steinberg is a master at issuing overvalued securities. In 1986, for example, Reliance Group issued $150 million of stock at $10 per share, and in 1993 it raked in another $200 million by issuing stock at $8 per share. (The registration statement for Reliance Surety is supposed to be filed by the end of the month, and should make for interesting reading—especially the "Risk Factors" section.)

Reliance's surety business is notable among Reliance Insurance Company's operations in that it makes an underwriting profit. In 1997 and 1998, written premiums were $176 million and $204 mil-lion, respectively, and underwriting profits were $38 million and $54 million. (Excluding surety and fidelity, the rest of Reliance's insurance operations generated underwriting losses of $69 million and $106 million.)

Reliance's surety and fidelity business is a *division* of Reliance Insurance Company, and virtually all the Reliance companies are part of the Reliance pool. As a result, they benefit—or suffer—from the financial results of the pool. It will be intriguing to see how Reliance Surety attempts to disentangle itself from the woes of its parent. We suspect that any plan that walls off assets (the good-company/bad-company approach), will not be viewed favorably by regulators or litigious competitors.

Some questions: How will Reliance capitalize Reliance Surety? Will the Reliance Pool act as a front and reinsure the surety and fidelity business into Reliance Surety? Can Reliance Surety's insurance company maintain an A- rating independent of Reliance Insurance Company? Finally, what is Reliance Surety worth?

We'll take a stab at the last question. In the past three years, Reliance's surety business has averaged a $42-million underwriting profit. One presumes that Reliance Surety will earn investment income on the assets offsetting its unearned premiums and loss- and loss-adjustment reserves. In addition, it should earn money on whatever capital is contributed. To further simplify our calculations, we'll be a sport and say that the surety market isn't cyclical and that intense competition won't drive profitability into the sea.

So let's say that Reliance Surety Group will earn $60 million pretax and $40 million after tax. (Whatever the profits actually are, it's worth remembering that, in the past, they were *included* in Reliance Group's results. Reliance Group *will not create one penny of economic value* for itself by selling part of Reliance Surety Group to the public unless it sells it to the public for more than it's worth.) CNA Surety, the only public company comparable to Reliance Surety, trades at about ten times earnings. If Reliance Surety—which is saddled with a tremendous negative: it's controlled by Steinberg—trades at a similar multiple, it would be valued at $400 million.

Accounting Magic

In theory, Reliance Group's valuation already includes the implied $400-million valuation for Reliance Surety (e.g., the surety business is an asset and some of Reliance's other business are liabilities). Steinberg, however, is hoping to alter the public's perception of Reliance Group's value. "The IPO will unlock this value," he declared, "and, at the same time, enhance our capital base."

For the moment, let's assume that Reliance Surety completes its IPO and achieves a $400-million valuation. Let's also assume that, post-IPO, Reliance Surety has a book value of $200 million.

We suspect that Steinberg, who knows how to make tin look like gold, will have Reliance Group carry Reliance Surety on the *equity* basis rather than on a *consolidated* basis. This would have no economic impact on Reliance Group's intrinsic value, fundamentals, or earnings, but would—through the magic of Generally Accepted Accounting Principles—enlarge Reliance Group's reported book value by about $200 million.

Reliance's legerdemain does not end here. The board has also approved a preliminary plan to *unlock more value* by spinning off 10% of the common stock of "a new e-commerce company," Point, Click & Bind, Inc., which will comprise the business of CyberComp, Reliance's "Internet-based writer of workers' compensation insurance policies for small-sized companies." Reliance's press release noted that CyberComp generated $81 million in gross premiums in 1998 and $71 million in the first half of 1999. It didn't say how much money CyberComp lost. (We're assuming that if the company made money, the press release would have noted that.)

Reliance's spin-off strategy calls to mind James Ling's "Project Redeployment," the scheme employed by ill-fated LTV in 1965. As Robert Sobel later wrote, "The putative reason for this unusual procedure had almost nothing to do with efficiencies, management, or improvement of internal growth, though years later Ling would claim all of these had been involved. Rather, he planned to shuffle his holdings to provide each with greater visibility and *boost the price of their Paper*… [emphasis added]."

The Reliance Surety and Point, Click & Bind transactions aren't Steinberg's first foray into the spin-off game. In 1968, his computer-leasing company, Leasco, used a grab bag of overvalued securities to acquire the much larger Reliance Insurance Company. Leasco, the holding company, eventually changed its name to Reliance and, in 1979, an incarnation of the old Leasco was spun off to Reliance shareholders.

The new Leasco then proceeded to buy Reliance, and Steinberg eventually took the whole shebang private in a leveraged buyout financed with debt and preferred stock. Reliance's 1986 IPO—underwritten by Drexel Burnham Lambert, courtesy of Mike Milken—was intended to generate funds to repay the debt incurred from the LBO. Reliance planned to raise $320 million to $380 million by issuing 20,000,000 shares priced at $16 to $19 apiece. In addition, Steinberg and his family planned to unload 4,300,000 of their shares. The market, however, wasn't receptive to this ploy, and the IPO had to be cut back to 15,000,000 shares priced at $10 each.

If Steinberg does pull off his variation of Project Redeployment, we wouldn't be surprised to see a whirlwind of complex transactions follow. Perhaps Reliance Surety or Point, Click & Bind will attempt to exchange some newly-issued convertible preferred and a package of warrants for Reliance Group's debt. The possibilities are endless.

Back in 1994, Saul Steinberg gave an impassioned speech at the Professional Liability Underwriting Society's annual conference. In his nasal whine (uncannily reminiscent of comedian Gilbert Gottfried's), Steinberg claimed that the insurance industry faced "enormous challenges from a host of enemies." His enemies list included the tort system, the "personal injury bar," regulators and politicians, and "the arrogant and complacent attitudes of many senior executives" in the insurance business who, he claimed, had forgotten their responsibility to their shareholders—namely, earning a good return on their investment.

As far as Reliance was concerned, Steinberg didn't know what he was talking about. To paraphrase Pogo, Steinberg had met the enemy, and it was him.

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Reliance Group's Day of Reckoning

The Reliance Surety Deal

SAY WHAT YOU WILL about Saul Steinberg, Reliance Group's chairman and CEO. He may be an overpaid wheeler-dealer, an overleveraged speculator, and an over-the-hill greenmailer—but he's got balls.

Steinberg, who is really smart—perhaps too smart—has made his money by finding value and piling on debt. Over the years his company has been a prodigious issuer and buyer of junk bonds. It has also been a big issuer of a special form of equity know as "junk stock."

In the summer of 1998, when Reliance Group's stock was approaching 20—it's now $3\frac{9}{16}$—Steinberg could have deleveraged the company. At the end of 1998, Reliance Group had $720 million of debt and $12.8 billion of assets (at least $520 million of which were intangibles) perched atop a $1.3 billion sliver of shareholders' equity. Steinberg, who was then 59, should have done what he was shrewd enough to do when he was in his twenties: issue stock, warrants, convertible preferred, and convertible debentures. He could have exchanged Reliance's soaring shares for some of its debt and built up a balance sheet that would have been comforting when the cyclical winds of the insurance and financial markets howled at his door.

But Steinberg didn't delever when the markets were smiling at him. Why? The answer, we suppose, has more to do with psychology than finance. For at least 30 years Steinberg has placed layers of leverage upon layers of leverage, creating a delicate financial puff pastry.

Indeed, Reliance has been so leveraged that earlier this year, when Steinberg told shareholders that the *still* highly leveraged Reliance "entered 1999 with more capital and less leverage than at any time in its history," he wasn't pulling anyone's leg.

Reliance Group's strategy of applying the financial leverage of debt to the operating leverage of an insurance business with long-tail liabilities is one that would make a good case study at Wharton, where Steinberg is chairman of the Board of Overseers.

Leverage is a magnifier: it makes good results better and bad results worse.

Steinberg knows this, and yet, for some reason, didn't raise enough capital when the easy money was available. Now that Reliance has been pummeled and is facing the specter of a rating-agency down-grade that could put it out of business, Steinberg is seeking capital and resorting to the financial legerdemain of spin-offs and asset shuffles.

Although we won't be there while Donaldson, Lufkin & Jenrette and Bear, Stearns attempt to peddle shares in newly formed Reliance Surety Group, we imagine that they'll pitch the deal as an opportunity to get in at a bargain price because Reliance Group is—alas—strapped for cash.

Reliance's Debt Yields 22%

Donaldson, Lufkin & Jenrette knows a thing or two about Reliance; it was the lead underwriter in the company's 1993 refinancing. Reliance's 9% Senior Notes, due next year, and its $9\frac{3}{4}$% Senior Subordinated Debentures, due in 2003, closed at 88 and 77, respectively—prices that say that bond buyers have serious misgivings about Reliance's solvency. (A buyer of the senior notes would make 22% in a year if Reliance Group makes the interest and principal payments when they come due.)

Bondholders and stockholders would probably feel better about Reliance had Saul Steinberg and his younger brother Robert not received $38,000,000 in salary over the last three years (this figure does not include options). On the other hand, bondholders and stockholders who feel disappointed by the collapse of Reliance's bonds and stock have only themselves to blame. Saul Steinberg has been overpaid for ages, and his corporate strategy of rapid growth, leverage, and concentration of risk has looked dangerous for ages.

As for Reliance Surety, it certainly *appears* far more desirable than Reliance Group. But appearances can be deceiving. While there are those who will see in Reliance Surety a stock worth buying, we see a Trojan Horse—an insurance company with Saul Steinberg inside.

Caveat emptor.

Read the Risk Factors

Reliance Surety's financials don't differ materially from the estimates we made in our October 25 issue (prior to the filing of the S-1 registration statement). Some details of the deal and its structure are intriguing, however.

Reliance is in weaker financial condition than its peers, and that poses a bit of a problem. Reliance's insurance companies are currently rated A- (Excellent) by A. M. Best. "If the Reliance Insurance companies' A. M. Best rating were downgraded for any reason, it could have a material adverse effect" [emphasis added] on Reliance Surety's business, says the company's prospectus.

What might this "material adverse effect" be? Not much, really—other than the "effect" that people wouldn't do business with Reliance Surety.

Reliance Surety has attempted to protect itself from such a circumstance. "In the event of a downgrade of the Reliance Insurance companies," notes the prospectus, Reliance Surety "would have to rely on an arrangement with another insurer similar to [its] present arrangement with the Reliance Insurance companies. In this regard, [Reliance Surety has] entered into an agreement with a large international reinsurer rated A++ by A. M. Best, pursuant to which that company has agreed for five years to act, when [Reliance Surety requests], as co-surety" on Reliance's bonds.

Reliance Surety hasn't provided the name of the A++ reinsurer that has agreed to step in as co-surety, nor has it said what vigorish it will have to pay for such services. One presumes that if it had to pay a material amount—whether in fronting fees, reinsurance arrangements, or something else—then that should have been disclosed in the prospectus. (Reliance declined to comment, citing the "quiet period" prior to an offering.) So the question remains: how much does an A++ rated reinsurer charge to be on call to Reliance as a co-surety for five years?

Although Reliance Surety has been quite profitable for a while, in the insurance business, good results have a tendency to give way to bad results without advance warning. Like all lines of insurance, surety is exposed to a variety of cyclical risks. "Changes in economic conditions or reductions in government spending on public works could have a material adverse effect on our business," warns Reliance Surety's prospectus.

Contract surety bonds accounted for 69% of Reliance Surety's gross written premiums. Most of Reliance's contract surety bonds are for contractors engaged in the construction of public works projects such as highways, bridges, and schools.

"An economic downturn could result in financial weakness and bankruptcies of contractors, and a decline in the number of construction projects," says Reliance. "This could result in an increase in claims against us. In addition, our business volume could decline if federal, state or local governments reduce their expenditures for public works, or if less construction is undertaken."

The prospectus, of course, doesn't contain projections showing what the company's earnings—or lack thereof—might be during the next recession.

Investors who buy Reliance Surety's stock—or Reliance Group's bonds or stock—would undoubtedly expect to make outsized returns on their investments, since these investments carry considerable risk.

But what does a *policyholder* stand to gain by doing business with the Reliance Insurance Company?

Agents, brokers, and insureds should keep asking that question until they get a good answer. And Reliance Group's investors and creditors ought to consider what might happen if there is no good answer.

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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 buy-backs, 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. *continued*

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.

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 makes them more easily understood. (Some of the figures are more precise than others. Estimated premiums, for example, are inherently more quantifiable than estimated losses.)

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 below: *Reinsurance, Hollywood*

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. 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.)

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.

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.

The survival of Reliance—unlike that of its retrocessionaires—depends on its ability to dispense with its problem. 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 17) 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 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 paradox: Reliance's weakness may do it in, yet the fact that it is so weak could be the very thing that saves it.

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Reliance Insurance Company on the Brink

Ratings Too High

WE'VE BEEN WRITING about Reliance a lot lately, and with good reason. It's mired in problems, is in weakened financial shape, and faces the specter of potential rating-agency downgrades. Because Reliance's business is heavily dependant on commercial insureds, it needs "secure" ratings in order maintain the confidence of its clients and insurance brokers.

Reliance Insurance Company is currently rated "A- (Excellent)" by A. M. Best, "Baa2 (Adequate)" by Moody's, and "A- (Strong)" by Standard & Poor's. These ratings, which fall into the secure category, do not accurately reflect Reliance's precipitous condition.

Ratings are supposed to be a reasonable reflection of a company's financial strength and ability to pay claims, and should provide a dependable assessment of credit risk. Because Reliance is a large company in borderline condition, rating agencies are reluctant to lower Reliance's ratings to the "vulnerable" category and set off a chain reaction that would cause people to be more reluctant to do business with Reliance, which would put greater pressure on its business, which would further stress its finances, which would likely lead to its failure.

Rating agencies are loath to exert such an influence—even if that influence is the result of an honest assessment. A rating agency's job, however, is to give a blunt opinion, regardless of the consequences. Its attitude should be "Damn the torpedoes—full speed ahead!"

The Odds of Failure

Companies that have secure ratings are supposed to have a negligible chance of failing, particularly over the short term. A 1991 study of life insurance company failures conducted by Lee Slavutin showed that the 10-year failure rates for life-insurance companies with A. M. Best ratings of A+, A, and B+ were 0.3%, 1.4%, and 0.4%, respectively. A 1994 study by Best showed that the three-year failure frequencies for life/health companies rated A+, A, and B+ were 0.21%, 0.27%, and 0.36%.

A Moody's study of the five-year cumulative default rates for corporate bonds during the 1970-1993 period showed that the one-year default rate was virtually nonexistent for bonds rated "A" and higher. The default rate rose significantly as one descended the credit scale. It was almost 2% for "BB" bonds, and more than 8% for "B" bonds.

The question we pose, therefore, is this: does Reliance Insurance Company have one chance in a hundred of failing within a year? If it does, then it doesn't deserve its current ratings. Instead, it should probably carry a "B" rating—at most—from the rating agencies.

It's impossible to calculate the *precise* odds of Reliance's failing, but it doesn't seem rash to say that Reliance has a 5% or 10% chance of failing. (It doesn't seem rash to say that it has a 20% chance of failing, either.)

Of course, a company with a 10% chance of failing has a 90% chance of *not* failing. But property-casualty insurance buyers should generally confine their business to companies that have a *negligible* chance of failure. Since the premium paid is only a small percentage of the potential loss transferred, the failure of a property-casualty insurer can expose a policyholder to unmanageable risk. (A reasonable case can be made for taking greater credit risk when buying an investment product such as an annuity—assuming that one gets "paid" for taking that added risk. Annuities are like bonds, and one can assemble a diversified portfolio.)

On Monday, A. M. Best lowered Frontier's rating from A- to B++. This move may indicate a more aggressive posture by Best with regard to weaker companies that are on the borderline. (Although B++ is still considered a "secure" rating, many in the insurance market do not view it as such.)

No rating agency wants to get stuck by having a "secure" rating on a company that's in danger of failing.

The heightened competition between rating agencies does not bode well for weak companies.

Saul Steinberg, chairman and CEO of Reliance Group

What the ratings are supposed to mean: Excerpts from the rating agencies' definitions.

A.M. Best

Secure

A and A- (Excellent)	Assigned to companies which have, on balance, excellent financial strength, operating performance and market profile when compared to the standards established by the A.M. Best Company. These companies, in our opinion, have a strong ability to meet their ongoing obligations to policyholders.
B++ and B+ (Very Good)	Assigned to companies which have, on balance, very good financial strength, operating performance and market profile when compared to the standards established by the A.M. Best Company. These companies, in our opinion, have a good ability to meet their ongoing obligations to policyholders.

Vulnerable

B and B- (Fair)	Assigned to companies which have, on balance, fair financial strength, operating performance and market profile when compared to the standards established by the A.M. Best Company. These companies, in our opinion, have an ability to meet their current obligations to policyholders, but their financial strength is vulnerable to adverse changes in underwriting and economic conditions.
C++ and C+ (Marginal)	Assigned to companies which have, on balance, marginal financial strength, operating performance and market profile when compared to the standards established by the A.M. Best Company. These companies, in our opinion, have an ability to meet their current obligations to policyholders, but their financial strength is vulnerable to changes in underwriting and economic conditions.

Moody's

Strong

A	Insurance companies rated A offer good financial security. However, elements may be present which suggest a susceptibility to impairment sometime in the future.
Baa	Insurance companies rated Baa offer adequate financial security. However, certain protective elements may be lacking or may be characteristically unreliable over any great length of time.

Weak

Ba	Insurance companies rated Ba offer questionable financial security. Often the ability of these companies to meet policyholder obligations may be very moderate and thereby not well safeguarded in the future.
B	Insurance companies rated B offer poor financial security. Assurance of punctual payment of policyholder obligations over any long period of time is small.
Caa	Insurance companies rated Caa offer very poor financial security. They may be in default on their policyholder obligations or there may be present elements of danger with respect to punctual payment of policyholder obligations an claims.

Standard & Poor's

Secure

A	An insurer rated "A" has STRONG financial security characteristics, but is somewhat more likely to be affected by adverse business conditions than are insurers with higher ratings.
BBB	An insurer rated "BBB" has GOOD financial security characteristics, but is more likely to be affected by adverse business conditions than are higher rated insurers.

Vulnerable

BB	An insurer rated "BB" has MARGINAL financial security characteristics. Positive attributes exist, but adverse business conditions could lead to insufficient ability to meet financial commitments.
B	An insurer rated "B" has WEAK financial security characteristics. Adverse business conditions will likely impair its ability to meet financial commitments.
CCC	An insurer rated "CCC" has VERY WEAK financial security characteristics, and is dependent on favorable business conditions to meet financial commitments.

SCHIFF'S
INSURANCE OBSERVER
Evening Telegraph Edition
November 15, 1999 *Volume 11e • Number 6*

John Hancock's Unfair Demutualization Plan

Deceptive, Misleading and Coercive

Morgan Stanley Says Plan is "Fair"

Wit Capital Says Plan is "Unfair"

The Big Heat: Wit Capital Caves In

JOHN HANCOCK MUTUAL Life Insurance Company's demutualization is a milestone in the history of American mutual insurance. In 1998 Hancock threw in the towel on the now-discredited mutual-insurance-holding-company approach it had supported and announced that it would do a full demutualization, instead.

Sadly, Hancock's demutualization plan is structured in a manner that's unfair to the company's policyholder-owners. Some 2.1 million policyholders—including many large policyholders—who would have received about $1,500 of stock or less, will be *cashed out without their informed consent*. Hancock, which is not in need of additional equity, plans to do a $2-billion IPO. (The lead underwriter will be Morgan Stanley.) Most of the proceeds from the IPO will be used to cash out unwitting policyholders. If this plan is approved by the Massachusetts Division of Insurance and Hancock goes forward with its IPO as planned, institutional investors will, in all likelihood, get to buy Hancock shares at a significant discount to the company's intrinsic value. Meanwhile, 80% of policyholders will be cashed out in a manner that has negative tax consequences for them.

A public hearing regarding Hancock's plan will take place on November 17 and 18, in Boston. David Schiff, who opposes the plan, will be appearing as an "expert witness." Schiff, as always, will be testifying *pro bono*: he does not accept any fees, compensation, remuneration, or reimbursement of expenses. To read his November 8 pre-filed testimony in full, as well as that of former Vermont commissioner James Hunt, and senior officers of Wit Capital, go to www.HancockWatch.com., a website created by Adkins & Kelston, a law firm representing policyholders who are intervening in the proceedings.

Complex Plan

Like most demutualizations, Hancock's plan is extremely complicated and requires a significant base of knowledge and commitment of time to be fully understood. Given that it's so difficult for policyholders (and agents) to understand the plan, one would think that Hancock's directors, who have a fiduciary responsibility, would want to ensure that policyholders are able to comprehend what is happening. This could be accomplished by clear communication. The model we admire is that used by Warren Buffett in Berkshire Hathaway's annual letter to shareholders. (He has said that his letter is written so that it could be understood by an aunt who has been away traveling all year.) Hancock hasn't come close to this standard. Instead, its communication seems designed to *take advantage* of an aunt who's been away all year.

Hancock sent policyholders a seven-page glossy brochure that misinformed them of what their "membership rights" in the mutual insurer entailed. By leading policyholders to believe that their rights are negligible, Hancock is coercing its policyholders to vote for a plan that is not in their best interests.

In addition to the glossy brochure, policyholders received a 317-page, densely worded "Policyholder Information Statement" (PIS) that omitted material disclosures and important information necessary to make informed decisions.

Included at the back of the PIS was a five-page Morgan Stanley "fairness opinion" signed by Derek Kirkland, managing director and co-head of Morgan's global insurance group. The fairness opinion, however, is window dressing: its abstruse verbiage contains so many caveats that the "opinion" is really no opinion at all.

Kirkland and Morgan Stanley also have material conflicts of interest (some of which were not disclosed to policyholders) that render them unfit to issue a fairness opinion in connection with the plan. Morgan Stanley was John Hancock's advisor in formulating the demutualization plan and, more importantly, will be the lead underwriter in Hancock's $2 billion initial public offering (which should generate about $100 million in fees for the underwriters). Morgan Stanley's substantial financial interest in seeing the plan approved creates an unconscionable conflict of interest that shouldn't be tolerated by the Massachusetts Division of Insurance. (Goldman Sachs had a similar conflict of interest in Principal Mutual's reorganization, and its opinion was subsequently thrown out by Terri Vaughan, Iowa's insurance commissioner.)

Derek Kirkland and Morgan Stanley had a conflict of interest in Provident Mutual's attempted mutual-holding-company conversion that is strikingly similar to their conflict of interest in the John Hancock matter. (Excerpts from David Schiff's cross-examination of Kirkland at the Provident hearing can be found on page 17 of the May 1998 issue of *Schiff's Insurance Observer*.)

Kirkland obviously knows a thing or two about insurance, and certainly holds himself out as an expert. And yet, at the Provident hearing, when given easy questions, he gave answers that were simply amazing.

"Do you have an opinion," Schiff asked, "about what Provident Mutual is worth?"

"No," Kirkland replied. "We have not evaluated what Provident Mutual will be worth."

Although Kirkland had already testified that Morgan Stanley was "continually involved in the valuation of securities" in connection with "public offerings, private placements, mergers, acquisitions and restructuring transactions" and that

Morgan was a "leading financial advisor to the domestic insurance industry," both he and Provident's CEO professed not to have any opinion about Provident's value. That raised the obvious question: if they didn't know what Provident was worth, how could they say that one form of reorganization was better than another—much less "fair"? "Fairness," after all, is relative. If there were other forms of reorganization that would have created greater value for Provident and its policyholders, then the plan that Morgan Stanley said was "fair" could not possibly be so.

Kirkland, Morgan Stanley, and Provident received their comeuppance on September 17, 1999, when Judge Stephen E. Levin issued a damning decision which found that the directors and officers of Provident Mutual, in their attempt to convert Provident into a mutual-insurance holding company, had "breached their duty of disclosure [to policyholders] because they disseminated a Policyholder Information Statement which unfairly described the Plan of Conversion, and therefore prevented policyholders from making an informed vote on the Plan." In other words, policyholders were *tricked* into voting for the conversion plan.

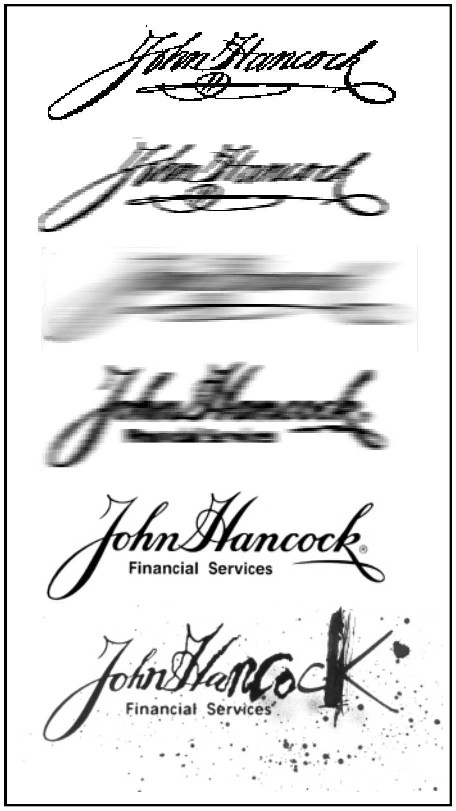
Judge Levin permanently enjoined Provident from effectuating its conversion until it issued a Policyholder Information Statement (PIS) that contained something absent from the PIS sent to policyholders—the truth. (Provident recently withdrew its application to convert to a mutual holding company, and there's speculation that the company will now do a full demutualization.)

Which brings us back to the John Hancock plan.

Just as Provident breached its fiduciary duty to policyholders by sending out a PIS that failed to disclose material information, so, too, does Hancock. And just as Kirkland and Morgan had said that Provident's misleading and unfair plan was "fair," Kirkland and Morgan are opining that Hancock's plan and PIS are "fair."

The Abusive Cash-Out

As part of Hancock's plan, concurrent with its IPO, about 80% of policyholders will be cashed out. Because the PIS sent to policyholders was misleading and coercive, the vast majority of policyholders will



not have given their informed consent regarding this cash-out. Particularly troubling is the fact that unless a policyholder completes and returns a complicated "ballot," "taxpayer identification information," and "cash/stock compensation election," John Hancock "will assume that" the policyholder "prefer[s]" to be cashed out. (Even if a policyholder checks the "stock selection box," if the form he returns isn't properly signed and returned by November 30—many months before the IPO—he may be cashed out.)

This default-to-cash situation is unfair and prejudicial to policyholders who are allocated a small amount of shares. (The share allocation process is troubling, but we won't get into that here. For more information, see James Hunt's pre-filed testimony at www.HancockWatch.com.) There is little reason to think that policyholders would prefer to be cashed out at a price that would probably be considerably lower than Hancock's private market value, and there is little reason to think that most policyholders would prefer to receive cash—which is taxed—rather than stock, which would not be taxed.

It is cruelly ironic that Hancock's plan calls for unsophisticated policyholders to have to make the complicated cash/stock decision by November 30—and make it based upon inadequate and misleading information—whereas "sophisticated" (to use Kirkland's term) institutional investors will not have to make *any decision at all* until much later: *after* they've had the benefit of a "road show" not available to policyholders and *after* they are told the price that they will have to pay to buy shares. (Policyholders who have to choose between cash and stock are required to make their decision without knowing what the price of the stock will be. Furthermore, even if they choose stock, they won't receive their shares until approximately seven weeks after the IPO, and therefore won't have the opportunity that institutional investors will have: to sell their stock in the public market on a favorable short-term basis.

Presumably, Hancock's officers and directors who are policyholders will receive stock rather than cash, and it is anticipated that they will also receive stock options in the future.

The Morgan Stanley Hustle

There's no reason for Hancock to cash out its uninformed policyholders. Furthermore, if Hancock plans to issue stock, it's only fair that shares be made available to its policyholders (who are the current owners), so that they can avoid having their economic interests diluted.

In an analogous situation—the 1998 MONY demutualization—stock was issued to institutional investors at a bargain-basement price. David Schiff protested this giveaway by speaking with MONY in advance, testifying at a New York State Department of Insurance hearing, and writing to New York's superintendent of insurance, Neil Levin, who's a former Goldman Sachs investment banker.

Schiff explained that a provision should be made for policyholders to buy shares. (This could be accomplished through subscription rights or some other method.) Schiff proposed another alternative as well: that policyholders be given an opportunity to buy restricted shares (at the offering price) after the offering.

Superintendent Levin didn't bother to respond to Schiff. (By sheer coincidence, Levin's former employer, Goldman, Sachs, was the lead underwriter of MONY's IPO.)

Hancock and Morgan Stanley were

probably familiar with the circumstances surrounding the MONY demutualization, and, undoubtedly, are aware that a demutualization can be a highly charged issue. Yet Hancock went ahead with a plan that would cash out 80% of its policyholders and make no provision for policyholders to participate in an IPO.

In a May 26, 1999 letter, Morgan Stanley's Kirkland advised John Hancock that a "subscription rights offering would be technically possible," but advised against it for a variety of reasons, many of which were absurd. ("The offering will only benefit those policyholders who participate." "These shares will not be available for sale in an IPO, which will reduce Hancock's ability to sell its shares to institutional investors.")

Kirkland implied that if institutions didn't get in on the ground floor, "coverage of Hancock by research analysts also will be limited, because analysts historically are reluctant to cover companies with limited institutional ownership." (Kirkland seemed to overlook the fact that John Hancock is a household name and one of the largest life-insurance companies in America; its size virtually assures that analysts will cover it. But even that is beside the point.)

"Without analyst coverage," wrote Kirkland, "Hancock also risks having a less liquid market for its shares, making it more difficult for *institutions* to buy and sell sizable blocks of stock and therefore *hurting the liquidity and ultimately the value of the stock* held by policyholders." [Emphasis added.]

Kirkland's thoughts on "liquidity" are not surprising. Morgan Stanley, after all, is a securities dealer; it makes money trading stocks and transacting an institutional brokerage business.

But there are many investors who don't share Kirkland's self-serving opinions. Take Warren Buffett, for example, who wrote the following: "One of the ironies of the stock market is the emphasis on activity. Brokers, using terms such as 'marketability' and 'liquidity' sing the praises of companies with high share turnover….But investors should understand that what is good for the croupier is not good for the customer. A hyperactive stock market is the pickpocket of enterprise." Buffett knows that value is inherent in the enterprise, not in the trading activity of the enterprise's shares.

We suspect that Kirkland knows this as well, but you can't tell it from his statements. He wrote that if institutions weren't given an opportunity to buy a meaningful part of Hancock's shares, then institutions would view Hancock's individual shareholders as " 'overhang'—future selling pressure that will limit share price appreciation." In short, Kirkland seems to be espousing the view that over the long run, stock prices are controlled by the supply of shares rather than by underlying business fundamentals—that the price of a company's stock is not determined by the company's earnings, growth, and book value, for example, but rather by how many shares are available for institutions to purchase.

Wit Capital's Monkey Wrench

In pre-filed written testimony submitted on November 8, two senior executives of Wit Capital messed up the Hancock/Morgan scheme, and the stunning turn of events that followed exposed the cynical nature of Wall Street.

Wit Capital is a publicly traded online investment banking firm. Its "goal is to empower individual investors—giving them access to opportunities and resources long available only to institutions and wealthy investors." Wit was formed in 1996 and is now populated by high-level investment-banking executives who left major firms to work at Wit. Wit has been an underwriter of 154 public offerings, and its own shares sport a market cap of $1.6 billion.

In his written statement, William Feeley, managing director and head of capital markets at Wit, wrote that Wit could provide a program by which Hancock policyholders could participate in Hancock's IPO. He also said the following: that Wit has experienced "very high rates of participation" in its "Directed Share Programs"; that Wit "disagree[d] with a number of the positions and statements made by Morgan Stanley"; that Wit didn't see eye-to-eye with Morgan Stanley regarding the institutional ownership issue; and that "absent an offering in the form outlined herein, we find that [Hancock's] Plan is *prejudicial to Hancock policyholders* and that the *financial loss associated with the transfer to outside investors at the expense of policyholder-owners is unfair and prejudicial to them*." [Emphasis added.]

Robert Mendelson, Wit's senior vice president and co-general counsel, concurred with his colleague's opinion. (The statements submitted by Feeley and Mendelson can be viewed at www.HancockWatch.com.)

The weight of evidence against the Hancock/Morgan approach, combined with Wit Capital's opinions, posed a threat to Hancock's plan, and to Morgan Stanley, which expects to profit from Hancock's demutualization (as well as from the demutualizations of other large insurance companies in the future).

On the morning of November 10, *The Wall Street Journal* ran the following headline: "Wit Assails Advice Morgan Stanley Gave John Hancock." The article that followed was a mere 400 words.

Wit Flip-flops—Suffers TKO

By the afternoon of November 10, Wit Capital, the champion of the individual, the company whose mission is "to empower investors…through the use of the Internet," was, apparently, beginning to understand that on Wall Street it's one thing to *talk* about empowering the little guy, and quite another thing to try to do so—especially if it's at the expense of the powers that be.

What transpired the morning and afternoon of November 10 may never be known, but at some point Wit decided that it wanted to disavow its 18-page pre-filed written testimony that was so damaging to Hancock and Morgan Stanley.

Why? One can only surmise.

In its role as an online investment bank, Wit needs to receive allocations of shares in other investment bankers' underwritings. In order to receive these allocations, Wit needs to maintain a good relationship with these firms. Ordinarily, that wouldn't seem like a difficult thing, given that Wit's honchos are a bunch of high-powered Wall Street folks with years of experience.

The day after *The Wall Street Journal's* first article, another article appeared. This time the headline read, "Wit's Chief Says Criticism of Advice Was Premature."

Although Wit's pre-filed testimony was detailed, Ron Readmond, Wit's co-chief executive, told *The Wall Street Journal* that Wit had made its statement "*without the opportunity to fully review the facts or talk to Morgan Stanley or John Hancock*." He also said that he believed that "Morgan Stanley has provided sound and thoughtful guidance to John Hancock."

We called Readmond to find out more about his epiphanic 180-degree turnaround, but, apparently, he'd left work early and was unavailable for comment over the weekend.

But let's examine his words.

He claimed that Wit had made its statement "*without the opportunity* to fully review the facts." Who denied Wit this "opportunity"?

Readmond claimed that Wit had made its statement "without the opportunity *to fully review the facts*." What "facts"? The relevant ones are in public documents. (Or, equally important, are *missing* from public documents).

Why is it relevant, as Readmond told *The Wall Street Journal*, that Wit had made its statement "without the opportunity to fully review the facts *or talk to Morgan Stanley or John Hancock*"?

Policyholders, who are required to make *their* decisions by November 30, don't get to talk to Morgan Stanley or John Hancock. (Policyholders *can* call an often busy toll-free "Conversion Information Center" and speak with uninformed clerks.)

What is relevant is that policyholders must make their decisions based on the Policyholder Information Statement (PIS), and the PIS is supposed to speak for itself. It either provides full and fair disclosure or it doesn't. And the plan itself is either fair or unfair.

So what accounts for Wit's turnabout? Did it feel the heat from Morgan Stanley? Did it get squeezed by the big firms that want to protect their turf? Did it realize that it could end up sleeping the big sleep if it continued to provoke the lords of Wall Street and attack them in the place that hurts them most—their wallets?

Readmond told *The Wall Street Journal* that, to the best of his knowledge, Morgan Stanley hadn't contacted Wit to complain. But had Morgan Stanley complained to someone else? Did some other investment bank that expects to participate in the Hancock IPO call Wit to complain? Did Wit's advisors hear complaints?

Wit's sudden reversal leaves a foul smell in the air, and it sends a message that it's not a good idea to mess with Morgan Stanley or any other "bulge bracket" underwriter, because if you do, you'll be crushed.

But Wit's words are set in type and available for the world to see on www.HancockWatch.com. Wit's executives won't be testifying at the Hancock hearing, but their words will be there, and the Massachusetts commissioner, Linda Ruthardt, may choose to wonder what really transpired between Wit, Morgan, and Hancock.

When it comes to demutualizations, the regulators aren't really in control. The process is dominated by the big mutuals, their associations, their lobbyists, their lawyers, and their investment bankers.

Hancock's demutualization plan is wrong, and so is Morgan Stanley's fairness opinion. But they've got a lot of money on their side, and they've created the rules.

As the great fight trainer Charley Goldman once said: "Never play a guy at his own game: Nobody makes up a game in order to get beat at it."

Nowhere to Hide

Hancock and Morgan Stanley won't get beaten at *their* game. But it's likely that they'll be beaten at a different game. The stakes in the John Hancock deal are too large, and the company's profile is too high. Does it really believe that it can cash out 80% of its policyholders and justify a bad deal by using Morgan Stanley's conflict-of-interest-tainted opinion?

We shall see.

In the meantime, Hancock and Derek Kirkland can ponder the words of Joe Louis, who said of Billy Conn, "He can run, but he can't hide." ■

SCHIFF'S
INSURANCE OBSERVER
Evening Telegraph Edition
December 2, 1999 *Volume 11e • Number 8*

The Story of Conseco's Disappearing Profits

*Capital Infusion—
But at a Cost*

Interesting Accounting

WE'VE BEEN WARY OF Conseco since we first wrote about it in February 1994, when the company's stock was trading at around 13½. Since then we've followed the company's exploits, written a number of skeptical articles, and watched the stock levitate to 57⅞ before declining to about 20.

After Conseco acquired Green Tree Financial in 1998, it issued a press release stating that it "remain[ed] comfortable" with analysts' consensus estimates that it would earn $4.08 per share in 1999. Around the same time, *The Indianapolis Star* reported that "Conseco chairman Stephen Hilbert said he is more certain than ever that the purchase of…Green Tree will help the company deliver high-level performance. He said to expect 20%+ growth in earnings per share for the foreseeable future."

As it turned out, the "foreseeable future" was not even a year. On September 8, 1999, somewhere between 25% and 50% of Conseco's "earnings" vanished with the stroke of a pen. To hear Conseco tell it, the bookkeeping change that made its earnings vanish (doing away with "gain-on-sale" accounting for its finance business) was just a timing issue. (Conseco instituted its new accounting method in the third quarter—which happened to be the first quarter in which one could have compared 1998 and 1999 quarterly results on an apples-to-apples basis.)

The company explained that under the *portfolio* method of accounting, earnings would be lower now, but higher later. Said CFO Rollin Dick, "We expect that operating earnings per diluted share for the full year 1999 (including two quarters of results under our historical method and excluding revenues from securitizations already completed on a gain-on-sale basis this quarter), will be approximately $2.95." (If Conseco hadn't included the first two quarters of 1999 under its historical method, earnings might have been projected at about $2.10 per share.) Dick said that earnings per share should grow to about $3.00 per share in 2000, *and that annual earnings growth thereafter should exceed 15%*.

Perhaps nothing illustrates Conseco's adroitness better than the fact that despite predicting $4.08 in earnings per share and 20% growth—and then announcing a 25% to 50% *decline* in earnings instead—it immediately went back to its old ways and predicted 15% annual growth going forward. (Of course, the new "growth" would be starting from a lower level. At a 15% growth rate, Conseco wouldn't earn $4.08 per share until 2002.)

Conseco's contortions call to mind the disheveled comic, Professor Irwin Corey, whose métier was rambling double-talk. ("The independent indications indicate that the market may fluctuate. Sometimes it flucks up, and sometimes it flucks down.")

To borrow a phrase from Professor Corey, Conseco flucked up—and flucked down.

A Desperate Deal?

On November 30, Conseco announced a deal with Thomas H. Lee Equity Fund IV that would result in an infusion of $478 million. Lee will purchase $500 million of Series F preferred shares convertible into common stock at 19¼. The preferred shares carry a 4% dividend, most of which will be paid by the issuance of more Series F preferred shares.

If Conseco's Series F preferred shares can be bought at 19¼, then the company's common stock should be worth about 20% less than 19¼. Put another way, Conseco wouldn't have issued the Series F preferred if it could have issued common stock at a similar price.

The logic of this argument notwithstanding, Conseco's stock rose 1⅝ to 20¼ on the news of Lee's investment. The market (which isn't always efficient) seemed to be saying that Conseco's apparent commitment to less leverage was a good thing.

Concomitant with the sale of stock, Conseco made two other announcements: 1) Conseco Finance will "manage" (read *slow down*) the growth of its finance receivables to levels consistent with the company's goal of seeking improved credit ratings, and 2) Conseco will cut its quarterly dividend from 15¢ per share to 5¢.

Predictably, Hilbert added a Corey-esque spin of obfuscatory bafflegab to these "strategic initiatives." The dividend cut, for example, was not a sign of financial strain or weakness. Instead, it was a decision "driven by our desire to strengthen the balance sheet and the importance of attaining higher ratings. As a growth company, we believe our shareholders will be better off if we reinvest earnings."

If Conseco is a "growth company," it is not one of those growth companies whose earnings will *grow* next year.

"After implementing these steps," Hilbert said, "we expect that our 2000 operating earnings per share will be approximately $2.80." That's 20¢ less than the figure Rollin Dick predicted three months ago.

Although Hilbert's predictive powers failed him in the last year or two, he hasn't lost his remarkable ability to predict the foreseeable future. "We expect," he said, "to generate earnings per share growth of 20% per year or more, beginning in 2001."

To recap: last year Conseco said it would earn about $4.50 per share in 2000. Three months ago it said it would earn $3.00. And two days ago it said it would earn $2.80. But don't tell this to Hilbert. Floyd Norris of *The New York Times* reported that during a conference call with analysts, Hilbert noted that Conseco *had never missed a quarterly earnings target*.

Before considering matters further, it's worth pondering Conseco's history of employing aggressive accounting to increase earnings per share.

In the past, the company has performed magical feats that have demonstrated that Conseco's hand is quicker than most people's eyes.

Questionable Accounting

Conseco has purchased insurance companies with almost no money down. It has made stock acquisitions. It has done poolings. It has used purchase accounting. It has sold off partial interests in subsidiaries to the public. It has bought back some of the subsidiaries' shares. It has repurchased its own stock. It has repurchased its shares through its insurance-company subsidiaries. It has sold companies. It has repurchased spun-off companies. It has managed an LBO fund that bought life-insurance companies. It has granted giant reload stock-option packages to its executives and then, when the options were deep in the money, repurchased the exercised shares from the executives at prices that were higher than the executives would have gotten in the open market. It has made loans to its executives. And it has guaranteed loans to its executives so that they could buy massive amounts of Conseco stock.

Conseco has also shifted its accounting methods enough times so that even the most learned accountants have trouble tracking one year's results versus another's.

For example, Conseco has carried insurance subsidiaries on its balance sheet on the equity basis (showing an entry for the value of the subsidiary); at other times it has used a consolidated basis (showing the assets and liabilities of the subsidiary combined with the company's other assets and liabilities). Conseco has recognized income when a partially-owned subsidiary, Bankers Life, issued stock—even though none of the proceeds went to Conseco. Yet it didn't reverse that bookkeeping "income" when, a short while later, it then purchased Bankers' stock at prices higher than that which Bankers had issued shares. (See *Schiff's Insurance Observer*, April 1995, pp. 4-8.)

Conseco's past is relevant because the company's growth strategy has hinged on leverage and acquisitions. Indeed, Conseco Inc. is an amalgam of insurance companies, most of which were acquired in leveraged transactions. (Due to rating agency pressures, it is no longer feasible to make leveraged acquisitions the way Conseco once did.) Conseco's companies, many of which are being rebranded under the Conseco name, sell life insurance, annuities, and supplemental health insurance.

Conseco Finance Corp. (formerly Green Tree), which was acquired for stock in 1998, makes loans, primarily on manufactured homes. In bad years, of which there have been a number, it has taken huge write-offs, negating previously reported profits.

If you don't like leverage, aggressive accounting, financial legerdemain, and ultra-bold projections, you will probably dislike Conseco's stock at almost any price. We bring this up because for many years Conseco has been a subject of controversy among bulls and bears. Where the bulls have seen a growth stock, the bears have claimed that the company's financial opacity masks a risky business.

The bearish case on Conseco is this: it is overleveraged, its acquisition of Green Tree Financial has been a disaster, and its reported and projected "earnings" are meaningless because its accounting methods—even if they conform to GAAP—are as smelly as a week old piece of Roquefort. In addition, a cash shortage is looming at the parent company.

It has been our experience that bears—shortsellers, if you will—tend to be more meticulous about their work than bulls. That's probably because they have to be in order to survive. A "short" can lose an unlimited amount on an investment that goes against him, whereas a "long" can only lose what he has invested. (That fact—and the prolonged bull market—are the reasons that there are so few dedicated shortsellers.)

"Conseco will grow 20% a year forever."

Hilbert and Conseco espouse the view that shortsellers are manipulators who try to drive a stock down by spreading misinformation. (Shortsellers—and others—espouse a slightly different view: that Hilbert is a huckster attempting to drive Conseco's stock up.)

Some of the recent controversy about Conseco has focused on the parent company's ability to service its obligations, and on its insurance subsidiaries' ability to upstream enough dividends (or fees or interest) to the parent company. (Hilbert claims that Conseco does not have a liquidity problem.)

High leverage, rapid growth, and insurance are not a healthy mix. If Conseco were not concerned about cash, why would it issue $500 million of stock at an equivalent of $15 per share when, in 1997 and 1998, it spent $640 million to repurchase shares at an average price of $40.80?

It has been noted that Conseco's main insurance subsidiaries, Bankers National and Jefferson National, have negative unassigned surplus. Some have posited that these insurers' dividend-paying capabilities are almost tapped out, and the issue has been raised as to whether regulators will allow Conseco to upstream enough dividends from its insurance subsidiaries.

Regardless of whether these insurance companies have a current ability to upstream money to Conseco, it seems reasonable to say that their continued ability to upstream enough dividends is not assured. (That, of course, is one of the reasons why leverage and insurance don't make an ideal combination.)

So Conseco must delever, which entails raising capital, selling assets (probably), and slowing growth.

That's no way for a "growth company" to behave.