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# Wasted Days and Wasted Nights

## *A.M. Best Finally Downgrades Reliance*

## *Rating Still Too High*

LAST THURSDAY AFTERNOON, after trading had closed on the New York Stock Exchange, A. M. Best finally got around to doing something that it should have done ages ago: it downgraded The Reliance Insurance Company. The downgrade, from "A- (Excellent)" to "B++ (Very Good)," was both long overdue and a step in the right direction, but it didn't go far enough. In addition to shaking up the staid rating-agency world, the downgrade provides some sort of answer to an article we wrote last August, "Reliance: Will Raters Pull the Trigger?"

Reliance is now in a position not dissimilar to that of The Home Insurance Company after Best downgraded it on November 7, 1999. (For more on that, see "So Long, It's Been Good to Know You," *Schiff's Insurance Observer*, November 22, 1994.) Reliance is like a punch-drunk fighter who, while caught on the ropes and being pummeled, is trying to play five-card stud with professional gamblers at ringside.

In Reliance's poker game, however, the company gets dealt three cards while the "gamblers"—Leucadia National—already have three aces showing and can fold at any time without losing the ante.

Best's downgrade is a devastating blow to The Reliance Insurance Company: it shatters any remaining pretense of its "excellent" financial strength, and is a skull-and-crossbones warning to insurance buyers throughout the land. It's also devastating for Reliance Group Holdings, which is desperate to sell itself to Leucadia. With its "B++" rating, Reliance will have difficulty retaining ratings-sensitive business on profitable terms. This is particularly challenging for Reliance, since a significant percentage of its business is ratings sensitive. As a result, Reliance is worth less and Reliance Group may be worthless. The likelihood has increased that Leucadia will either walk away from the deal or, as we suggested on June 5, it will significantly reduce its offer to Reliance Group's shareholders and strike a deal in which bondholders receive much less than par.

### New Deal

Here's our back-of-the-envelope analysis of what a restructured Leucadia-Reliance deal might look like: Leucadia offers Reliance Group's shareholders $50 million in stock plus a Contingent Value Right (CVR) that would give them up to another $50 million, depending upon reserve development, asset sales, etc. In order to eliminate a significant portion of Reliance Group's debt, Leucadia pays, on average, 50¢ on the dollar to Reliance Group's various creditors (whose obligations total $735 million), in an exchange offer that extends the remaining debt 10 years and reduces the interest rate to 7%. (The restructured Reliance Group would then have $368 million of debt, with annual interest payments of $26 million.) To entice creditors to accept the exchange offer, Leucadia throws in some warrants and CVRs as a kicker. In return for the concessions from creditors, Leucadia puts about $200 million—in the form of Empire Insurance Group—into Reliance. (If Leucadia doesn't put *something* in, it's hard to see how Reliance could even maintain its "B++" rating.)

In our scenario, Leucadia will have bought Reliance for $50 million of stock plus the contribution of Empire. It will have eliminated $368 million of Reliance Group's debt and refinanced the rest at a reduced interest rate. Leucadia would still be taking a sizable risk—which it can afford to do—and it won't have shelled out any cash or guaranteed any debt.

Our scenario isn't exactly *attractive* for Reliance's shareholders or creditors, but their alternative may be a Chapter 11 filing, which they may find even less attractive.

### The Downgrade—Why Now?

Since Reliance didn't turn bad overnight—and by some measures is stronger now than it was eight months ago—you might wonder why Best decided to downgrade Reliance at this time. (Like Best, Standard & Poor's and Moody's still rate Reliance as "secure." We're focusing on Best because it's the rating that the average person in the insurance industry looks at, and because Best carried Reliance at a higher rating than S&P or Moody's did.)

Because Best was maintaining Reliance at an artificially high level, and because Reliance's financial strength and its proposed deal with Leucadia are uncertain, Best was in something of a bind—and still is. "A-" companies are defined by Best as having "excellent financial strength, operating performance, and market profile…and a strong ability to meet their ongoing obligations to policyholders." Clearly, that description hasn't applied to Reliance for a long time. Reliance doesn't look much like a "B++" company, either. "B++" companies have "very good financial strength, operating performance, and market profile…and a good ability to meet their ongoing obligations to policyholders." In fact, Best's definitions that more accurately describe The Reliance Insurance Company are "C++ (Marginal)" to "C (Weak)".

Best has always been unduly wary of downgrading a company below "A-", fearing that such a rating could precipitate its collapse. But for an agency's ratings to have validity, the ratings must be an *unflinching* (and reasonably accurate) assessment of an insurance company's condition at a given time, even if such an assessment creates a crisis of confidence that could lead to a "run on the bank." A rating agency that pulls its punches is doing a disservice to current users of its ratings.

In the last 15 years there's been increased competition among rating agencies. Although Best once had a monopoly, it doesn't anymore. There are now three important players (Best, S&P and Moody's), two less important players (Duff & Phelps and Weiss), and one player whose ratings should be ignored (Demotech). Of the three most important raters, Best is perceived as being the most lenient; Moody's, which provides coverage on far fewer companies than the other raters, is perceived as being the most discerning.

A. M. Best is a *business*, and it can ill afford to have high ratings on a weak company like Reliance (which might fail) when Moody's, for example, has a lower, more accurate rating: "Baa2 (Adequate)."

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A. M. Best has tended to move slowly and "manage" its ratings down. For example, it downgraded Frontier Insurance Company from "A-" to "B++" on November 15, 1999. On March 17 it lowered the rating to "B", and on April 21 it lowered it again, to "C++".

Neither Frontier nor Reliance deserved the high ratings it had, but in Frontier's case, Best appears to have had fewer qualms about lowering the company's rating because a downgrade to "B++" would not be cataclysmic. (Frontier's business was less ratings-sensitive than Reliance's.) Nonetheless, Best apparently felt the need to move gradually even though Frontier didn't fit into the rating category it had been assigned.

Rating agencies shouldn't try to "manage" a company's ratings down over a period of months. Their job is to rate a company's financial condition—not prop up weaker companies.

According to Best, Reliance's rating will "stabilize" in the Very Good ("B++" and "B+") range if the Leucadia deal closes. "However, if the transaction is not consummated in a timely manner and satisfactory arrangements for debt refinancing are not made, A. M. Best would expect to further downgrade Reliance's rating."

If an insurance company needs to close a difficult deal, garner a capital infusion, and refinance its debt just to *maintain* a secure rating that it would not otherwise have, it stands to reason that the company doesn't deserve that rating.

Reliance doesn't deserve a "secure" rating from Best, S&P, or Moody's. Insurance buyers should consider Reliance extremely vulnerable and should do business with it only if they are comfortable doing business with a large insurer that has an unusually high risk of failing.

Insurance, after all, is bought to *transfer* risk.