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SCHIFF'S

INSURANCE OBSERVER

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Notes from the Insurance Beat

Insurance and Flags

GEORGIA INSURANCE COMMISSIONER John Oxendine likes to get involved in matters that are of no concern to policyholders, the insurance industry, or the state of Georgia. Which brings us to the saga of the National Council on Compensation Insurance (NCCI), a non-profit with 850 employees.

In a September 14 e-mail, NCCI president Bill Schrempf made a foolish, but ultimately harmless, mistake: he told employees that they couldn't have American flags on their desks. "Divisive statements or actions, political or religious discussions and anything else that could be divisive or mean different things to different people are not appropriate in our work environment," he wrote. The company removed flags from 10 employees' desks.

Schrempf's flag prohibition on a national day of remembrance and prayer turned out to be a gigantic blunder, and newspapers across the country gave the story play. On September 17, NCCI apologized to its employees and gave them American flags as they came to work.

That didn't satisfy commissioner Oxendine. "If they think handing out flags excuses their conduct, that's not the case," a *National Underwriter* article quoted him saying. The article said that Oxendine might decertify NCCI as a rating bureau in Georgia. "It's going to take a lot of explaining by their president to not change our relationship," Oxendine threatened.

On October 5, the embattled Schrempf resigned as NCCI's president. Oxendine, however, was still not satisfied. He said the Georgia Insurance Department would continue investigating and assessing the situation.

We called Oxendine twice to ask whether he was abusing his regulatory authority. After all, the flag imbroglio had nothing to do with NCCI's professional qualifications. Furthermore, NCCI is located in Boca Raton, Florida. Also, would Oxendine have threatened to take the same actions if NCCI had, for example, forbidden employees from displaying peace signs or political propaganda?

Oxendine did not return our calls or answer our questions.

On November 16, NCCI, which provides employees with on-site child care, a fitness club, flu shots, and take-home meals for those who don't have time for cooking, was honored by Child Care Resource & Referral for providing a "family-friendly workplace."

Commissioner Oxendine: your opinion please?

Not a Member of Citigroup

IN MARCH 1999, WE PUBLISHED a fourteen-page article about insurance companies' misleading advertising. One abusive practice we cited was the use of a parent company's name or logo in a way that implies that the parent company provides special financial support for the insurance company. Absent an explicit guarantee, parent companies are not obligated to support their insurance subsidiaries, and often will not do so, or cannot do so.

Condor Insurance Company, for example, advertised that it was "backed by the financial strength and stability of Amwest Insurance Group (rated A- 'Excellent' by A. M. Best)." Condor, now known as Far West, is currently in liquidation and is rated "F." So is its parent, Amwest.

Frontier Insurance Company advertised that it was "a member of Frontier Insurance Group (NYSE: FTR)—which is nearing Two Billion Dollars in assets." Frontier Insurance Group, which had only $1 billion in assets, is now under regulatory supervision and is rated "E."

Travelers Property Casualty Insurance Company has placed the phrase "a member of Citigroup" underneath its name and logo. The purpose of doing this, we suppose, is to make policyholders and insurance buyers think that Travelers Property Casualty is a better, more financially sound company because of its relationship with Citigroup.

As we have noted in the past, we never saw a great fit between Travelers Property Casualty and the rest of Citigroup. Sandy Weill now shares that opinion; Travelers Property Casualty will be spun off to Citigroup shareholders in 2002. As a result, Travelers Property Casualty will no longer be "a member of Citigroup."

Although Travelers Property Casualty is in strong financial condition, as an independent company it will not have access to Citigroup's capital, should the need arise.

Policyholders who bought long-tail policies based, in part, on Travelers' advertising its connection to Citigroup, will be getting less than they thought they bargained for.

What a Deal!

ROBERT CLEMENTS, CHAIRMAN of Arch Capital Group (formerly Risk Capital Reinsurance Company), has had an illustrious career at Marsh & McLennan. He was the driving force behind the formation of ACE and XL during the mid-1980s, and Mid Ocean in 1992. Clements also served as president of Marsh & McLennan and then chairman and CEO of MMC Capital.

In 1995, Clements became chairman of newly-formed Risk Capital Reinsurance (backed by Marsh & McLennan, MMC Capital, and J. P. Morgan). Risk Capital billed itself as a "merchant reinsurer"—it would provide its clients with "a choice of reinsurance and/or capital." Unlike traditional insurance companies, Risk Capital planned to invest heavily in insurance equities. In short, it would be a closed-end insurance-stock fund that wrote reinsurance. While this has a certain appeal, as we noted back in 1997, it's a concept that could be executed only in a bull market—precisely the time one doesn't want to buy stocks.

Risk Capital did not distinguish itself as an underwriter or investor. The company eventually redomesticated to Bermuda, sold its insurance operations to White Mountains, changed its name to Arch Capital, and began looking for something to do with its money. (It had gone public in 1995 at $20 per share, and book value is still around that level.)

On, November 20, Arch announced that it closed on $763 million in private-equity funding led by Warburg Pincus and Hellman & Friedman, bringing its capital to approximately $1 billion. Arch has hired several big hitters and plans to take another shot at the reinsurance business. In anticipation of the profits that it will achieve in the coming years, its stock has gone from $17 on October 22 to $25.75 today.

In connection with the $763 million transaction, Clements was granted 1,689,629 restricted shares. At $25.75 per share, the grant is worth $43.5 million.

Buy the Bonds, Not the Stock

BEFORE BUYING STOCK in a company, one should always check to see if that company has a fixed-income security that's a more attractive investment. Markets are inefficient, and equity is sometimes valued richly, while fixed-income securities—which provide greater protection—are not.

A case in point is CNA Financial. At $29 per share, the company has a market capitalization of $6.5 billion. CNA is a giant multi-line insurer and a perpetual turnaround story. Investors who buy the stock are probably doing so on the theory that CNA is "cheap" (75% of book value), that the worst is over, and that it really *can* be turned around.

If CNA's stock is a good investment—or even a somewhat bad investment—then its fixed-income securities should be an excellent investment. CNA Financial's 6.45% senior notes due January 15, 2008 are trading at 82, which provides a yield to maturity of 10.6%—about 600 basis points more than Treasurys, and 300 basis points more than similarly rated notes. (CNA's notes are rated BBB- by Standard & Poor's and Baa2 by Moody's.)

There is a disconnect between CNA's $6.5 billion equity market capitalization and the discounted prices for the company's $2 billion of debt. As students of Corporate Finance 101 know, if a company's debt isn't money good, then its equity is worthless. Thus, CNA's notes provide considerable downside protection compared to the stock under most circumstances. (If CNA becomes insolvent, then both the notes and the stock will probably be worthless, although an investor in the notes will, at least, have received interest payments.)

Suppose, however, that CNA's stock is undervalued, and three years from now is trading at $43.50. In that case, a shareholder would make 50% on his investment.

How would a noteholder fare in that scenario? We'll assume that the notes would trade around 96 (the theory being that the company's solvency is not in question). In addition, a noteholder would have received three years of interest payments. The total return, therefore, would be 40%—almost as much as the stock, but with much lower risk.

To recap: if the stock stays the same or goes down, the notes are a much better investment (and should earn a 10.6% yield to maturity). If the stock goes up 50%, the notes are almost as good an investment. Thus, it seems that the only circumstance under which an investor might prefer the stock to the notes would be if he thought the stock was going *way* up. (An investor with such confidence could always buy the notes on margin, however.)

When we bought the notes recently, our broker told us that Merrill Lynch's credit analyst had a negative opinion on them. At that same time, Merrill's stock analyst rated CNA as a "buy" for the "long term."

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Editor and Writer .... David Schiff
Copy Editor .... John Cauman
Editorial Associate ...... Isaac Schwartz
Production Editor .... Bill Lauck

Publisher .... Alan Zimmerman
Subscription Manager....... Pat LaBua
Advertising Manager ..... Mark Outlaw

Editorial Office
Schiff's Insurance Observer
300 Central Park West, Suite 4H
New York, NY 10024
Phone: (212) 724-2000
Fax: (212) 712-1999
E-mail: David@InsuranceObserver.com

Publishing Headquarters
Schiff's Insurance Observer
SNL c/o Insurance Communications Co.
321 East Main Street
P.O. Box 2056
Charlottesville, VA 22902
Phone: (434) 977-5877
Fax: (434) 984-8020
E-mail: Subscriptions@InsuranceObserver.com

For questions regarding subscriptions please call (434) 977-5877.

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