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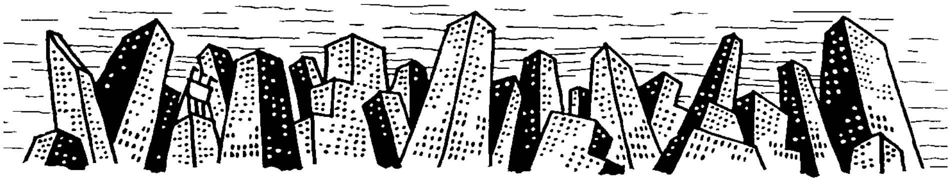

THE INSURANCE BEAT

Things Change

IN OUR LAST ISSUE WE discussed how Employers Re, a subsidiary of General Electric, had used the GE logo in its ads and stated that its policies were "backed by" GE's "resources" and "capital reserves." The ads were misleading and deceptive (because they gave the false impression that GE had financial responsibility for Employers Re's obligations). Two weeks ago, after General Electric made it clear that it wanted out of the money-losing reinsurance business, the major rating agencies, which had once given Employers Re top ratings, downgraded the company. It is now rated "A+" by Best, "AA" by Fitch, "Aa2" by Moody's, and "AA-" by S&P.

The meaning of a triple-A rating is worth pondering. If a company doesn't qualify for the rating *without* the implicit support of its parent company, should it qualify for it *with* the implicit support? ("Implicit support" means that the rating agencies believe that a parent company will provide financial support to its subsidiary, usually because the subsidiary is of great strategic importance to the parent. "Explicit support," on the other hand, is a legal obligation to provide financial support.) As we detailed in pages 3-16 of our last issue, implicit support often is not worth the paper it isn't printed on. Implicit support is not a contract, guarantee, pledge, or promise. Parent companies will only make good on implicit support when it's in their financial interest to do so.

The rating agencies have often been too loose with their ratings. In many instances they ignored the lessons of history and provided ratings to companies that, on their own, wouldn't have qualified for them. That may be changing, if for no reason other than the fact that there's greater competition among insurance raters than ever before. For a rater to be perceived as adding value, its ratings must be viewed as more discerning in some way than those of its competitors.

Gulf Insurance Group
A member of citigroup

Gulf's logo in 1999...

On December 3, Moody's downgraded the U.S. participants in the Gulf Insurance intercompany pool by two notches, from "Aa2" to "A1." Gulf is 76%-owned by Travelers and was part of the Travelers Property Casualty intercompany reinsurance pool (rated "Aa2") until September 30. Moody's noted that its downgrade of Gulf "reflect[s] to a greater degree than in the past, the stand-alone financial strength of the Gulf companies." Absent an explicit guarantee, shouldn't *all* ratings reflect the stand-alone financial strength of an insurance company? At the very least, shouldn't the rating agencies provide two ratings: their existing rating and a stand-alone rating?

Gulf
Insurance Group

...and Gulf's logo today.

In 1999 we wrote about Gulf's branding, which included the deceptive slogan, "A member of Citigroup," which gave the impression of greater financial strength to pay claims than actually existed. (Gulf also used the Travelers umbrella in its logo; it no longer does.) Citigroup will not be making good on Gulf's liabilities should the need arise; Travelers Property Casualty, including Gulf, was spun off on August 1.

The next day Trident II, an investment fund managed by MMC Capital (a subsidiary of Marsh & McLennan), paid $125 million for an interest in Gulf. Gulf's senior managers invested an additional $7 million. Perhaps Gulf will be spun off from Travelers Property Casualty one day.

In its press release announcing Gulf's downgrade, Moody's said that "the ratings of Gulf continue to reflect a certain degree of explicit and *implicit* financial support provided by Travelers, albeit at a reduced level than in the past." [Emphasis added.] Moody's also said that it "expects that Travelers will continue to provide support as needed to Gulf—both financially and operationally—so long as it continues to own a meaningful share of the group."

In other words, Travelers will provide financial support—until it stops providing financial support. Insurance buyers with long-tail liabilities may want to take that into consideration.

Why Take Risk?

ON DECEMBER 5, the European edition of *The Wall Street Journal* reported the following: "Zurich Financial Services said it will stop writing credit-enhancement policies, underlining the insurer's determination to leave risky businesses and focus on profitable insurance activities."

The article didn't say which lines of insurance were not risky.

Risk Factors

THE BAD NEWS FIRST: On December 3, Moody's downgraded 118 classes of asset-backed securities (ABS) issued by Conseco Finance (formerly Green Tree Financial). Approximately $9.46 billion of senior, mezzanine, and subordinated ABS derived from Conseco Finance's manufactured-housing loans were affected. Conseco Finance also defaulted on $4.7 million in guaranteed loan payments.

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And now the good news: Moody's *didn't* downgrade 14 classes of Conseco Finance's ABS.

The issuance of asset-backed securities has grown rapidly; the ABS market now stands at $1.4 trillion. According to *BondWatch*, the U.S. life-insurance companies with 10 largest ABS portfolios owned a total of $56.6 billion worth of ABS as of June 30. In Japan, where short-term government bonds yield virtually nothing and five-year bonds yield 0.34%, life insurers searching for—you guessed it—higher yields have increased their purchases of ABS.

The quest for yield involves risk. Although insurance companies have had a tendency to tell their shareholders that they plan to "stick to their knitting," they often enter new fields on the theory that a spontaneous combustion of synergy will occur. (When Conseco announced its acquisition of Green Tree, it claimed the deal provided "extensive cross-marketing opportunities." *Schiff's* saw it differently and suggested that "reverse synergy" might take place.)

Chubb is a good company and has a fine reputation. We've had our insurance with it for 27 years. But Chubb has been a poor manager of its capital, blowing money on stock buybacks and, sometimes, on businesses it would be better off without. In its recent prospectus, Chubb provided fair warning about some of the "risks" in its businesses. "Since its inception in 2000, Chubb Financial Solutions' non-insurance operations have been primarily in the credit derivatives business, principally as a counterparty in portfolio credit default swap contracts," the company stated. "These contracts generally require Chubb Financial Solutions to make payment to a counterparty to the extent cumulative losses on a portfolio of securities, loans, or other debt obligations exceed a specified amount." Chubb's credit derivatives business lost $55.9 million before taxes during the first nine months of this year.

Chubb also warned that if it has to pay obligations under "gas forward purchase surety bonds" it will be adversely affected: "We have in force several gas forward purchase surety bonds," Chubb said. "The total amount of bonds with one principal, Aquila, Inc., is $550 million. These bonds are uncollateralized. [Aquila's credit rating is at the "junk" level.] The combined amount of all other gas forward surety bonds is approximately $250 million. Approximately $140 million of these bonds are uncollateralized. There is currently no reinsurance in place covering our obligations under any of these bonds. These bonds are similar to some of the bonds that we issued on behalf of Enron Corp. on which payment was triggered by Enron's bankruptcy in December 2001."

Chubb is one of a number of insurance companies that has been sued by J.P. Morgan, which is seeking to collect $956 million from surety bonds issued for Enron-related oil and gas contracts. Chubb and the other insurers claim that they were duped into writing the surety bonds.

Perhaps that's true. When we attended the College of Insurance and studied the basics of suretyship, however, we were taught that surety bonds are supposed to be underwritten for zero losses. The surety assesses a principal's financial capacity, character, and capabilities. To be prudent, it often seeks collateral. Of course, we were taught this many years ago, before the existence of modern finance.

So why did Chubb and other companies write *uncollateralized* surety bonds for companies whose capacity, character, and capabilities were less than stellar?

The answer, undoubtedly, is that it seemed like an easy way to make money at the time.

Creative Financial Officers

TEN YEARS AGO MOST chief financial officers had a professional accountancy qualification. No longer, *The Economist* noted recently. According to a survey by Peter McLean of Spencer Stuart, only 20% of Fortune 500 CFOs are certified public accountants; 35% are MBAs.

The Economist suggests it's not a coincidence that, at a time when many CFOs are not CPAs, so many companies employ creative accounting. "An accountancy training encourages respect for numbers," the magazine writes. "An MBA breeds creativity. In the 1990s, the role of the CFO moved away from financial reporting in ways that made a broad business training more useful. CFOs became strategic planners...devising complex financial instruments, and above all, managing relations with investors."

The risk manager—once known as the guy who's in charge of insurance—ultimately reports to the CFO. It is the dream of many risk managers to turn their small fiefdoms into profit centers.

The purchase of insurance is an expense. It takes a really creative risk manager, CFO, and CPA to make it something else.

Insurance for Shareholder Value

AT THE 38TH ANNUAL conference of the Risk & Insurance Management Society (RIMS), held in spring 2000, financial-services firms and insurance companies gave risk managers a lesson in how to use insurance for balance-sheet manipulation and earnings management.

The lesson is recounted in two articles we saved from the May 15, 2000 issue of *Business Insurance*: "Using Insurance as Capital Adds to Company's Value" and "Shifting Balance Sheet Liabilities." The articles are straightforward accounts of panel discussions that took place at the RIMS meeting

"Insurance is a form of off-balance sheet capital," an employee of one of the largest reinsurers told the audience. "When you begin to think like this there's a payoff." The payoff wasn't the fees his company stood to earn; rather, it was the payoff a company could get by making itself *appear* more attractive to investors. "The payoff...might involve the reshaping of an enterprise's risk profile in the eyes of other stakeholders, such as investors, lenders, or clients," he said.

Is it honest for an enterprise to nobble its investors, lenders, and clients by camouflaging its true appearance? This question does not seem to have been raised.

Instead, risk managers were told that the "modern tool kit" to accomplish the payoff included "structured finance," "capital-relief transactions," "derivatives," and "enterprise-wide risk transactions." Using these a risk manager could, supposedly, make his company's stock price go much higher. "When you can create billions of dollars in shareholder value you're really talking about using insurance in an opportunistic way," said the fellow selling these tools.

Another panel at the RIMS meeting discussed how "risk management tools that allow businesses to *move a variety of liabilities off their balance sheets* can reduce costs while enhancing a company's appearance on Wall Street." [Emphasis added.] Risk managers could "collaborate with chief financial officers to stabilize earnings and cash flows."

And why would CFOs want to stabilize earnings through financial engineering? To make their companies appear more attractive to investors and lenders, who might, respectively, bid their stock prices up and lend more money.

It's no wonder many investors are wary of companies' financial statements.□

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