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INSURANCE OBSERVER

Disaster at Lumbermens and Kemper

Surplus Note Default?

"...and then Lumbermens' surplus notes traded for forty cents on the dollar."

On May 21, Lumbermens Mutual Casualty Company (aka the Kemper Insurance Companies), announced that its C.O.O. William Smith would succeed David Mathis as C.E.O. on January 1, 2003, and as chairman on April 1, 2003.

Yesterday, Lumbermens announced that Smith had "decided to retire" effective today. If Lumbermens were a stock, its price would be plummeting.

Lumbermens doesn't have stock, but it does have publicly-traded surplus notes, and the bond market, for what it's worth, is offering the opinion that the notes are likely to default. The bond market is also saying that there's a good probability that Lumbermens is (or will become) insolvent.

The rating agencies don't quite agree with the bond market. Best, Fitch, and Standard & Poor's still give Lumbermens low "secure" claims-paying ratings. Moody's has already downgraded Lumbermens' financial-strength rating to Ba1 ("vulnerable"), noting that the company's capital position is "strained."

The bond market thinks the raters are being too kind. Lumbermens has $700 million of surplus notes outstanding. (For the record, they are rated "junk" by all four rating agencies.) Although surplus notes are a form of debt, for statutory accounting purposes they are carried on insurance companies' balance sheets as capital rather than as a liability. (Surplus notes are subordinated to all policyholder liabilities, and interest and principal payments can be made only with the prior approval of the regulators after they've decided that the company's financial condition is sufficient to make the payment.)

Lumbermens has $1.5 billion of *reported* surplus. (Few have confidence in that figure.) If the company's surplus notes had been carried as a liability, reported surplus would be $800 million rather than $1.5 billion. (Lumbermens' total liabilities are about $7.4 billion.)

Lumbermens has two large issues of surplus notes outstanding: $400 million of 9.15% notes due in 2026, and $200 million of 8.3% notes due in 2037. If Lumbermens were in investment-grade financial condition, these notes would trade around 106. Instead, they're around 40, which, assuming the company doesn't default, provides a 23% yield to maturity.

Viewed another way, the bond market doesn't believe that Lumbermens has $1.5 billion of surplus; it's saying that there is, perhaps, $280 million of statutory surplus. (Surplus is what's left after paying all policyholder claims and liabilities. Since the market is valuing Lumbermens' $700 million of surplus notes at forty cents on the dollar—or $280 million—one can infer that bondholders believe that there's no cushion beyond that.) If Lumbermens has no surplus beyond $280 million to pay to its surplus-noteholders, then the company is obviously leveraged to the hilt and in precarious condition.

We don't know why Smith—who's in his late fifties and was slated to become C.E.O. tomorrow—retired. (He didn't return our call.) On December 12, both he and David Schiff were speakers at a conference sponsored by Standard & Poor's and the Black Diamond Group. When Schiff asked Smith whether Lumbermens had plans to demutualize, he replied that it was considering doing so. He also added something to the effect that he wasn't too sure if anyone would *want* Lumbermens' stock. That public comment, which went unreported by the press, struck us as unusual. We can't recall another occasion where we've heard the president of a company that is desperately seeking capital say something so pessimistic.

Part of Lumbermens' weak financial condition stems from deals that it engineered with its publicly traded stock affiliate, Kemper Corporation, in 1989 and 1993 (see "Watch Kemper Very Closely: The Lumbermens Shuffle," *Schiff's Insurance Observer*, June 15, 2001). In those deals, Lumbermens and Kemper—which had identical boards of directors in 1989 and overlapping boards in 1993—engaged in asset swaps that were detrimental to the mutual and beneficial to the public company. All told, the swaps cost Lumbermens more than $400 million (and made the same amount for Kemper Corporation).

Lumbermens executives and directors have been driven by greed. In 1998, Lumbermens lobbied hard to get a mutual-holding-company law passed in Illinois, the company's state of domicile. (As we've noted before, a mutual holding company is a neutron-bomb form of corporate structure: it knocks out policyholders but leaves a mutual's directors and officers standing—and filled with stock options.) In early 1999, Illinois governor Jim Edgar, whose term was about to end, signed a bill permitting mutual holding companies in Illinois. Seven weeks later Edgar joined the Lumbermens board of directors, from which he would receive at least $83,000 per year.

More than a decade ago, Joseph Belth, editor of the indispensable *Insurance Forum* (http://www.TheInsuranceForum.com) and a surplus-note skeptic, asked a good question: what would happen if a regulator refused to allow an insurance company to pay the interest or principal on a surplus note when the payment was due. The act of refusing to allow payment, he pointed out, would be a message to the world that the insurance company was in terrible financial condition, and could spark a run. (In general, life-insurance companies are more vulnerable to a "run on the bank" than are property-casualty companies.) On the other hand, permitting a weak company to pay interest would deplete its surplus and endanger policyholders.

It appears that Lumbermens Mutual, which was formed in 1912 to provide workers comp coverage for Midwestern lumber yards, will be the first test of Belth's question. Will the regulators allow Lumbermens, which is not flush, to make the $60 million or so of annual interest payments on its surplus notes? With the surplus notes at forty cents on the dollar, the bond market has already provided its answer—absolutely not.

The distressed surplus notes, Smith's "retirement," and pressure from the rating agencies bode ill for Lumbermens. On December 23, Lumbermens announced that it had an "agreement-in-principle" with Berkshire Hathaway's subsidiary, National Indemnity, in which National Indemnity (rated "A++") would provide a cut-through endorsement on policies issued under the agreement beginning January 1, 2003.

The "agreement-in-principle" is subject to "closing conditions" and other factors. According to Lumbermens, "closing is expected in the first quarter of 2003."

Even if the deal closes, it will have no effect on previous policyholders or on holders of the surplus notes. In the meantime, Lumbermens is open for business. The Kemper Insurance Companies ran a full-page ad in the December 16 issue of *Business Insurance* that said "...And, as with anything at Kemper, you'll always have the *integrity of our reputation* for financial stability and strength." [Emphasis added.]

Investors wishing to speculate on the integrity of Kemper's reputation for financial strength can purchase Lumbermens' surplus notes. Insurance buyers, on the other hand, should not speculate on financial strength.

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