The world's most dangerous insurance publication℠

SCHIFF'S INSURANCE OBSERVER

January 9, 2003
Volume 15 • Number 1

Death Spiral at Lumbermens and Kemper?

Slowly, then Suddenly

Big insurance companies that have been around for ages don't collapse in a day—they weaken gradually. They tend to underreserve, their surplus tends not to increase, and their underwriting results are often worse than average. Sometimes they try to grow their way out of their problems, writing business at rates that are too low, which usually makes their condition more bleak. Sometimes they hire a big gun from AIG, hoping to remake themselves in Hank Greenberg's image. (AIG, of course, doesn't just sit still and wait for those that are reinventing themselves to catch up with it.) Sometimes they borrow money. Sometimes they play accounting games with financial reinsurance. And sometimes they do all of the above.

Lumbermens Mutual Casualty Company (the lead company of the Kemper Insurance Companies) is one of the largest property-casualty insurance organizations in the country, and was, not long ago, one of the most important. It was founded in 1912 by James S. Kemper, who built Lumbermens and The Kemper Insurance Companies into a powerhouse. Along the way, Mr. Kemper also managed to make a lot of money for himself—rare for a *mutual*-insurance-company executive. (Kemper was a delegate to the Republican National Convention from 1936 to 1952, served as treasurer of the Republican National Committee from 1944 to 1946, and, after Eisenhower took office, was Ambassador to Brazil until 1955.) He died in 1981 at age 94. There's a good chance that Lumbermens, the source of Kemper's wealth, will not be a going concern for as long as its founder was.

As we said earlier, big insurance companies usually don't collapse suddenly. They collapse slowly—then suddenly. Problems build up over time. Sometimes, but not always, the magnitude of the problems becomes apparent. Once people understand that a company is weak, a death spiral often begins: brokers take their business elsewhere, adverse selection sets in, financing becomes difficult or impossible, and regulators monitor the company closely—all of which makes insurance buyers less inclined to do business with the company, exacerbating its already weak financial condition. Whether Lumbermens is in a death spiral may be a subject for debate. What isn't debatable is that *we* wouldn't do business with a company that might be in a death spiral and whose ability to stay in business is dependent upon external financing that may not be forthcoming.

Kemper Insurance Companies

Financial strength is often taken for granted by insurance buyers and insurance-company managers. Although AIG and Berkshire Hathaway are keenly aware of the importance of *extreme* financial strength, many are not. Chubb's Dean O'Hare horrified us six years ago (see *Schiff's Insurance Observer*, April 1997) when, in Chubb's annual report, he told shareholders that "We have an obligation—one I feel most strongly—to *maximize* the value of our shareholders' investment. *This means ensuring that we are adequately, not over-adequately, capitalized*." [Emphasis added.] Chubb then embarked on a $2.4-billion multi-year share repurchase (its average repurchase price was almost $67 per share; the stock is now $57). Chubb debased its balance sheet—it's still pretty strong, however—and destroyed value in the process. Many once-mighty insurance companies have done much worse.

Insurance buyers tend not to value extreme financial strength—and usually won't pay up for it. Lumbermens, for example, has been on a decline for a long time. Best downgraded it from "A+" to "A" way back in 1991, but that didn't seem to have a noticeable affect on its ability to write business. (The Kemper Insurance Companies have written more than $30 billion in premiums since then.) In fact, the Kemper Insurance Companies even came to the rescue of a company in weak condition. On April 6, 2000, Kemper—which has been a large writer

Lumbermens Mutual Casualty Company's Surplus Notes

Lumbermens has $700 million of surplus notes outstanding. The notes carry low "junk" ratings and trade at distressed levels (in the 40s), which indicates that investors believe default is likely. (The surplus notes are subordinated to policyholder liabilities.) Given that the surplus notes make up a considerable amount of Lumbermens' statutory surplus, it appears that there is scant margin of safety for Lumbermens' policyholders.

Issue	Amount Outstanding	Maturity	Interest Rate	Annual Interest Payments	Payments Due
30-Year Notes	$400,000,000	7/1/2026	9.15%	$36,000,000	January 1, July 1
40-Year Notes	$200,000,000	12/1/2037	8.30%	$16,600,000	June 1, December 1
100-Year Notes	$100,000,000	12/1/2097	8.45%	$8,450,000	June 1, December 1
TOTAL	**$700,000,000**			**$61,650,000**	

Source: Fitch Ratings

of comp in California—provided a cut-through reinsurance agreement for policyholders of Superior National, which was insolvent and under the supervision of the California Department of Insurance. "I am extremely pleased to have the support and assistance of Kemper in our effort to rehabilitate Superior National," insurance commissioner Chuck Quackenbush said in a press release. "Kemper... adds great value and experience and will help us protect Superior National's good book of business." The press release said that the cut-through protection provided "coverage that allows policyholders and injured workers covered under new and renewal policies to submit claims directly to Kemper in the event Superior National is ultimately unable to pay those claims. The new 'cut-through' agreement... does not diminish the protection available from the insurance guaranty fund that will pay 100% of California workers' compensation claims should that protection become necessary."

Now Kemper needs a cut-through from a stronger company. If all goes as hoped, Berkshire Hathaway's National Indemnity will provide the cut-through that will allow Kemper to keep writing business.

At the time of the Superior National cut-through, the Kemper companies weren't in excellent condition according to *all* rating agencies; they were in "good" financial condition. S&P and Moody's rated them "A" and "A2," respectively. A review of the rating actions for Lumbermens and Kemper—and for Lumbermens' surplus notes—follows:

On April 12, 2002, Fitch downgraded the Kemper Insurance Companies (Kemper) to "BBB" from "A." Lumbermens' surplus notes were lowered to "junk" level: "BB-," from "BBB-."

On May 7, Best lowered Kemper to "A-" from "A."

On August 15, Moody's downgraded Kemper to "Baa1" from "A2," and lowered the surplus notes to "junk" level: "Ba1," from "Baa2."

On September 12, Fitch lowered Kemper to "A-."

In a September 30 report, Moody's—which still had Lumbermens at a "secure" rating—noted that the company's "surplus deterioration raises red flags." Lumbermens surplus was $1.5 billion, $700 million of which was from surplus notes. Additionally, as of December 31, 2001, Lumbermens had entered into a retroactive reinsurance arrangement with Berkshire Hathaway in which it ceded $550 million of reserves and paid premiums of $352.5 million, which boosted statutory surplus by $197.5 million. (Although Lumbermens reported greater statutory surplus as a result of the transaction, it will lose the investment income that it would have earned on the premiums paid; the transferred reserves, which are for A&E, will be paid out over many years.) Moody's also noted that "total reinsurance recoverables as a percentage of capital is highly aggressive." *Nonetheless, Moody's didn't give Lumbermens a "vulnerable" rating.*

On October 24, Fitch wrote that its insurance ratings reflected the fact that there "had been a material deterioration in the financial profile of the Kemper organization." *Fitch still gave the organization a "secure" rating, however*. Fitch also noted that Lumbermens had boosted its surplus from the finite reinsurance deal with National Indemnity—without this, Lumbermens' risk-based-capital ratio might have fallen below the company action level at the end of 2001—and that Kemper's "credit risk exposures related to reinsurance recoverables [were] high when compared to peers." Fitch also said that on an "unstacked" basis (not including the surplus in its insurance subsidiaries), almost all of Lumbermens' surplus was made up of its outstanding surplus notes. "Such a level of financial leverage [is] extreme," Fitch wrote, "and inconsistent with an investment-grade rating...It appears [that] Lumbermens may face challenges in funding interest payments to surplus note holders in 2002 and beyond."

On December 20, Moody's was the first rating agency to lower the insurance companies below "secure," downgrading them to "Ba1 (questionable)." The surplus notes were lowered to "B2 (poor)." Standard & Poor's lowered the insurance companies to "BBB-" and the surplus notes to "BB" the same day.

On December 24, Best downgraded Kemper to "B+ (very good)," and the surplus notes to "bb-."

On December 31, *Schiff's Insurance Observer*, which had criticized Lumbermens a year and a half earlier, published "Disaster At Lumbermens and Kemper: Surplus Note Default?" For what it's worth, we received more immediate feedback on that article than on anything else we've ever written.

On January 7, Fitch downgraded the Kemper Insurance Companies to "B+ (weak)." The surplus notes were lowered to "CCC (very weak)."

Finally, on January 9, as we were getting ready to go to press, Moody's downgraded the insurance companies to "Ba2" and the surplus notes to "Caa1." Standard & Poor's downgraded the insurance companies to "BB+" and the surplus notes to "B+."

Given that Lumbermens' surplus notes sport junk ratings from all the raters (and extremely low junk ratings from two of the raters), the overall financial condition of Lumbermens itself must be considered questionable. Although surplus notes are subordinated to policyholder liabilities, if a leveraged insurance company's junior obligations carry a high risk of default, there isn't a considerable margin of safety for the senior obligations.

Generally, interest and principal payments on surplus notes can be made only with the prior approval of the regulators. Given Lumbermens' precarious position, one would expect that the regulators might not approve interest payments until the company's solvency was assured. On December 1, 2002, Lumbermens made a $12.5 million interest payment on two of its surplus notes. On January 1, 2003, it made an $18.3 million interest payment.

The annual interest obligation on Lumbermens' surplus notes is $61.6 million. A $12.5 million interest payment comes due on June 1, 2003, and $18.3 million comes due on July 1, 2003. Will the regulators allow these payments? The market is pricing Lumbermens' surplus notes in the 40s—a clear indication that investors believe that default is likely. Surplus-note holders have little recourse in the event of a default. They cannot put the company into bankruptcy, nor can they seize assets. In fact, they can't do much of anything other than hope that somehow they will get some of their money back. (The issuance of surplus notes was rare until recent years. According to *The Insurance Forum*, life-health companies had $400 million outstanding in 1981. At the end of 2001, insurance companies had $23.8 billion outstanding.)

With the exception of Best, all the major raters have Lumbermens and Kemper in the "vulnerable" category. (Best will probably hop on the bandwagon sooner rather than later.) The death spiral, we believe, is well underway.

The world's most dangerous insurance publication℠

SCHIFF'S
INSURANCE OBSERVER

Editor and Writer . . . . David Schiff
Production Editor . . . . Bill Lauck
Foreign Correspondent . . Isaac Schwartz
Copy Editor . . . . John Cauman
Publisher . . . . Alan Zimmerman
Subscription Manager . . . . . . Pat LaBua

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

Annual subscriptions are $149.
For questions regarding subscriptions please call (434) 977-5877.

Reprints and additional issues are available from our publishing headquarters.
Insurance Communications Co. (ICC) is controlled by Schiff Publishing. SNL Financial LC is a research and publishing company that focuses on banks, thrifts, real estate investment companies, insurance companies, energy and specialized financial-services companies. SNL is a nonvoting stockholder in ICC and provides publishing services to it.