The world's most dangerous insurance publication℠

SCHIFF'S

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INSURANCE OBSERVER

Damn the Policyholders! Full Speed Ahead!

The PMA Shuffle

Insurance regulation is a balancing act. Regulators must weigh the interests of insurance-company owners, policyholders, and the public. The interests of insurance-company shareholders are often at odds with those of policyholders. Shareholders, presumably, want to maintain as little capital as possible in insurance companies and invest that capital however they please. Generally speaking, it is the regulator's role to ensure that insurance companies are run in a reasonable manner and remain solvent. That said, it is not possible to achieve a one hundred percent solvency rate. In theory, states could prescribe levels of capital and risk that are so conservative that no insurance company would fail. But if the states insisted on such an extreme level of conservatism, investors wouldn't put money into insurance companies and, eventually, insurance would be unavailable, or its cost would be prohibitive.

In recent years, Pennsylvania has been home to a number of large insurance-company failures, including those of Reliance Insurance Company (insolvent by $3 billion), PHICO, and Legion/Villanova. One question worth asking when an insurer is in a weakened state is whether the insurance department acted wisely to protect policyholders. In the case of Reliance, for example, the Pennsylvania Department of Insurance stood by as the company paid billions in dividends to its parent company over the years. Some of these dividends were paid when Reliance was in especially precarious condition. While we cannot state unequivocally that Pennsylvania has the worst insurance department, we can say that based on what we have observed, regulation in that state is often skewed in favor of insurance companies' management and shareholders in

"I sold my soul for about a tenth of what the damn things are going for now."

a way that's detrimental to policyholders. Pennsylvania, for example, permits mutual insurance companies to do subscription-rights demutualizations that take advantage of their policyholders. The state permits abusive mutual-holding-company conversions. (The Pennsylvania Department of Insurance has the ignominy of having approved the only mutual holding company conversion—that of Provident Mutual—that was subsequently enjoined by the courts.) The largest insolvency in history is a Pennsylvania company. And Pennsylvania is the home of the "good bank - bad bank" concept of dealing with troubled insurance companies.

In the following article we'll take a look at PMA Capital Insurance Company, domiciled in Pennsylvania. At its peak in 2002, it was the eleventh largest broker-market reinsurer in the country. By 2003, it was in run-off, the result of poor underwriting and too rapid growth. Despite PMA's weakened financial state, the Pennsylvania Department of Insurance approved a restructuring that allowed PMA's parent company to withdraw nearly sixty percent of PMA's surplus—about $300 million—increasing the risk that PMA will have insufficient capital to pay its claims in full.

What follows is a story about insurance, politics, power, success, failure, and regulation. It may serve as a reminder that insurance departments—especially Pennsylvania's—are often more concerned about protecting local corporate interests than policyholders' interests.

PMA Capital Insurance Company's roots go back to 1909, when Joseph R. Grundy, a conservative Bucks County businessman, founded the Pennsylvania Manufacturers Association. In his role as president of the association, Grundy crusaded for the enactment of workers compensation legislation in Pennsylvania that would limit the right of injured workers to sue their employers. When legislation was passed in 1915, he incorporated the Pennsylvania Manufacturers Association Casualty Insurance Company to underwrite workers compensation insurance.

The Pennsylvania Manufacturers Association says that "business in Pennsylvania is our business." It lobbies for laws and regulations that benefit its members, monitors proceedings at the state legislature, and is, in its own words, "a champion of free markets and a favorable business climate." Only walking-distance from the state Capitol in Harrisburg, the association at times serves as a gathering place for business leaders. According to a 1929 editorial in *The Nation*, the association was "the most powerful organization of its kind." Says Paul D. Beers, a Pennsylvania historian, "PMA has been a wing of the Republican Party. When you support one party for 100 years, you are very much in the family."

In 1929, Grundy, who, according to Beers, favored " high tariffs, low taxes, and special privileges for industry," was appointed by Pennsylvania's governor to fill an interim vacancy in the U.S. Senate until 1930. Grundy lived another thirty-one years, dying at the age of ninety-eight. In the years since his death, the association has lost some of its clout. "It regressed with Pennsylvania losing manufacturing jobs," says Beers. "The big manufacturing is gone."

The association's current chairman, Frederick W. Anton III, has long been active in the Republican party in Pennsylvania. He was also chairman and CEO of PMA Capital Corporation, the insurance company's parent, where he worked for forty-one years. (The insurer's previous chairman, F. Otto Haas, CEO of Rohm & Haas, had joined the insurer's board in 1947 at Grundy's invitation, and was a longtime advisor to and supporter of many of Pennsylvania's governors, senators, and members of the state legislature.) Anton is also chairman of the PMA Foundation, which, until a couple of years ago, owned 17.7% of PMA Capital Corporation—about 5.5 million shares worth $140 million at their peak. These shares represented the entirety of the Foundation's assets, and it relied on dividends on these shares to fund the operations of the Pennsylvania Manufacturers Association. In 2003, after reporting large losses, PMA Capital eliminated its dividend, its stock lost much of its value, and the Foundation sold most of its shares.

The Pennsylvania Manufacturers Association Casualty Insurance Company, diversified into reinsurance in 1970, forming PMA Reinsurance Corporation in 1980. By 1998, the reinsurer had become PMA Capital Corporation's largest business, responsible for half of its $564 million in premiums. "PMA Re is a prominent United States reinsurer and has contributed the most significant portion of our consolidated operating earnings for many years," wrote PMA Capital Corporation's CEO, John W. Smithson, in 1999.

On November 1, 2000, PMA Capital Corporation completed a restructuring designed to increase PMA Re's capital from about $300 million to more than $500 million. The increase was achieved by "restacking" PMA Capital Corporation's subsidiaries. The workers compensation companies—Pennsylvania Manufacturers Association Insurance Company, Pennsylvania Manufacturers Indemnity Company, and Manufacturers Alliance Insurance Company, collectively known as the PMA Insurance Group—became subsidiaries of PMA Re, which then changed its name to PMA Capital Insurance Company. A surplus lines company, Caliber One, also became a subsidiary of the renamed PMA Capital Insurance Company. Smithson wrote that as a result of the restacking, "PMA Capital Insurance Company now has statutory capital and surplus of more than $500 million, which gives us a more desirable profile than having separate operating companies capitalized at less than $300 million each. This structure more accurately reflects *the true level of capital we have* in support of our collective underwriting. [Emphasis added.] Stephen G. Tirney, PMA Re's president and chief operating officer, wrote that the restacking was done because "many clients require their reinsurers to have $500 million in policyholders' surplus. By realigning our capital structure, we continue to have the policyholders' surplus buyers want." Three-and-a-half years later, the company's clients would discover that the increased surplus was illusory and that the restacking was, in fact, something of a bait-and-switch.

PMA Capital Insurance Company's increased surplus gave it the wherewithal to write considerably more reinsurance. Between 2000 and the end of 2002, the company more than doubled its number of reinsurance clients, to 390, and net premiums written swelled from $262 million to $639 million. It was not, however, a propitious time to take on so much risk, and PMA Capital Insurance Company was floundering. It reported a $3.1 million operating loss in 2001, and $13.4 million of operating income in 2002, a long way from the $50 million and $46 million operating incomes it had reported in 1999 and 1998, respectively. In 2002, its surplus-lines operation, Caliber One, lost $88 million and was placed into run-off.

continued

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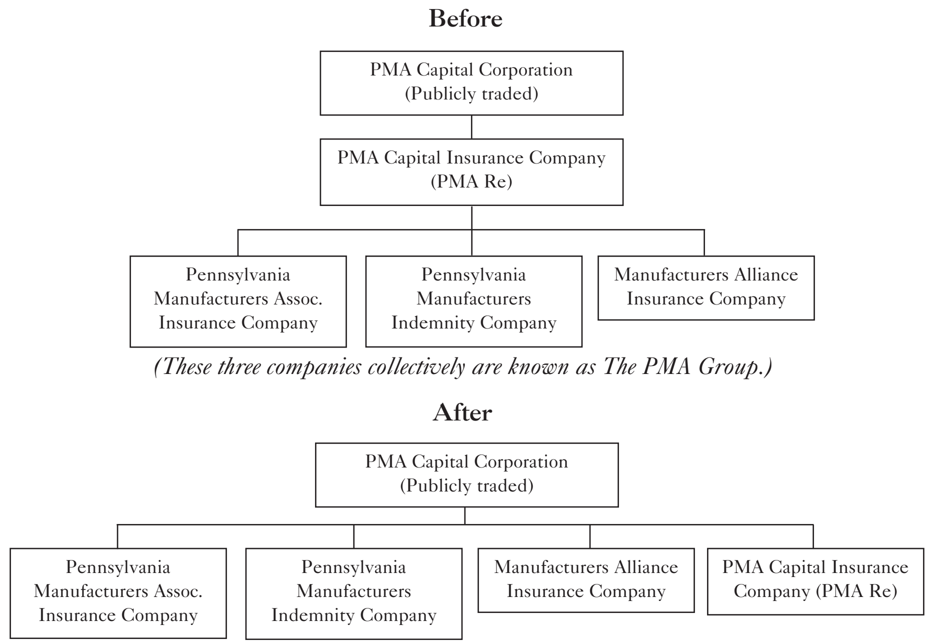
PMA Unstacked

Before the 2004 unstacking, PMA Capital Corporation's main businesses were direct subsidiaries of PMA Capital Insurance Corporation, also known as PMA Re. After the unstacking, The PMA Group of insurance companies, which had about $300 million of surplus, became direct subsidiaries of PMA Capital Corporation. The unstacking was completed by having PMA Re declare an extraordinary dividend of the PMA Group.



On February 5, 2003, PMA Capital Insurance Company announced a $26 million reserve charge for its reinsurance operations. Three weeks later, A.M. Best downgraded the insurance company from A to A-. (It had been downgraded from A+ on November of 2000.)

On November 4, 2003, PMA Capital Corporation. announced a $150 million pre-tax charge at PMA Capital Insurance Company and the elimination of its common stock dividend. PMA's stock, which had fallen from the mid-$20s to $13.14, fell sixty percent that day, to $5.03. Best, S&P, and Moody's downgraded PMA Capital Insurance Company and PMA Insurance Group to B++, BBB-, and Ba1, respectively.

Two days later, PMA Capital Corporation announced that it was withdrawing from the reinsurance business and putting PMA Capital Insurance Company into run-off. The company also announced the resignations of its CEO, John W. Smithson, 58, and chairman, Fredrick W. Anton,70. Both were well taken care of: Smithson collected $1.5 million and Anton will get $420,000 per year for life. Anton remained chairman of the PMA Foundation and the Pennsylvania Manufacturers Association. (In an unusual addendum, the SEC subsequently filed a complaint alleging that Anton tipped off a retired PMA employee about the bad news and the dividend cut before it was made public, telling him that he had "too many eggs in one basket." The employee, who sold 40,000 PMA shares, paid more than $786,000 to settle civil charges, neither admitting nor denying any wrongdoing.)

On December 22, 2003, PMA Capital Insurance Company entered into an agreement with the Pennsylvania Department of Insurance that allowed it to keep a closer watch on the reinsurer. The agreement consisted of twenty-eight separate clauses that the insurance company had to abide by. For example, it was required to provide the insurance department with monthly financial information and a plan for satisfying its liabilities. It had to inform the Department of any commutations it would carry out with cedants, and it agreed not to enter into new reinsurance contracts. Furthermore, it could not, without the prior approval of the Department, pay dividends to PMA Capital Corporation or alter its Pennsylvania-domiciled insurance company subsidiaries' ownership structure. (PMA's 10-K filing with the SEC described this agreement as "voluntary.")

On April 9, 2004, PMA Capital Corporation filed an application with the Pennsylvania Department of Insurance to rejigger its corporate structure by unstacking the PMA Insurance Group companies, which had about $300 million of surplus, from PMA Capital Insurance Company, leaving the reinsurer with about $220 million of reported surplus versus $1.2 billion in reserves. The unstacking would reverse the restructuring that had been completed in 2000, and raised a good question: is it proper for an insurance company to increase its surplus to attract business, and then once it has gotten that business, remove the surplus, leaving policyholders in an impaired position?

Although Pennsylvania's insurance law specifies various conditions for corporate restructurings involving insurance affiliates, it gives the commissioner great discretion. In order for PMA Capital Corporation's application to be approved by the Pennsylvania Insurance Commissioner, it had to meet a vague legal burden: the commissioner had to find, among other things, that after completing the transaction, "the insurer's surplus shall be *reasonable* in relation to the insurer's outstanding liabilities and adequate to its financial needs." [Emphasis added.]

PMA Capital Corp.'s application to the Pennsylvania Insurance Department included letters from an actuarial firm and an investment banking firm. Kevin Ryan, vice-president and principal of the actuarial firm Bickerstaff, Whately, Ryan & Burkhalter, said that he had reviewed PMA Re's reinsurance contracts and loss-and-loss-adjustment expenses and had concluded that the quoted reserves were "reasonable." However, his letter said that in arriving at a range of liabilities, his projection was "based on the Company's historical experience and we have not anticipated any extraordinary changes to the various factors that might impact the future cost of claims."

The investment banking firm Keefe, Bruyette & Woods also provided something that looked like an opinion. It wrote that "as of the date [of the letter], assuming that the Proposed Transaction is consummated as proposed, immediately before and after and giving effect to the Proposed Transaction…the admitted assets of PMA Capital Insurance Company will exceed its liabilities…" Keefe, Bruyette's letter had many caveats, including a lack of an opinion about PMA's projections and PMA's ability to pay its debts as they came due. Keefe, Bruyette said than in reaching its conclusion, it relied on information provided to it by PMA without "any responsibility for independently verifying the accuracy or completeness of any such information."

Despite the impact of the unstacking, PMA Capital Insurance Company did not notify its reinsureds about what it was doing. The only notice of the application appeared in a government publication, the *Pennsylvania Bulletin*. It gave interested parties forty-five days to file comments with the Pennsylvania Department of Insurance.

It appears that most of PMA's cedants were not aware of the restructuring plan, and many that were aware only learned about it near the close of the comment period. Resorting to email at the eleventh hour, Doyle Johnson, a director at Federated Mutual Insurance Company, wrote that he "did not become aware of the deadline for submitting a written response to the Department until this past Friday, May 21, 2004 with the deadline being today, May 24, 2004."

Janet Fagan, vice president and chief actuary at Wisconsin-based Sentry Insurance, wrote that "the notice does not seem consistent with the basic reinsurance principle of utmost good faith. [We] believe that PMA Capital Insurance Company should have sent notice directly to all its reinsurance clients."

Thirty-two of PMA Capital Insurance Company's nearly 400 reinsureds submitted comments to the insurance department. All opposed the unstacking application. The cedants universally cited the diminished surplus that would be available to protect their interests after the unstacking. A few requested guarantees from PMA Capital Corporation—the publicly-traded holding company—in case PMA Re became insolvent. Some, especially those with less nuanced positions, requested more time to study the issue.

In a letter representative of many of the objections raised, Fagan wrote, "When Sentry accepted PMA Re [as] a participant in its reinsurance program, PMA Capital Insurance Company was an A.M. Best A+ rated company with over $500 million in surplus…The reduction in financial strength created by the proposed restructuring is of such a scope as to be in direct contradiction to the representations made to [us] by PMA Reinsurance management at the time PMA Re was accepted…[We] would not have accepted PMA Re with the asset picture that would result from the proposed restructuring."

Most letters were short, but a few stood out for their detailed protestations. In a seven-page letter, Joseph Schiavone of Budd Larner, a law firm representing St. Paul Travelers, requested that the insurance department follow the procedures that had been used for CIGNA's proposed restructuring. Wrote Schiavone, "This would include the retention of independent experts by the Department, the solicitation of written submissions by interested parties and the public, oral presentations by such persons, and ultimately, the issuance of a written and detailed decision and order by the Department."

PMA Capital Corporation's senior vice president and CFO, William E. Hitselberger, responded to all letters that objected to the unstacking application. In general, his responses were dismissive.

Gary Miller, CEO of Baldwin & Lyons, another cedant, wrote a six-page letter discussing the problems with PMA's plan: "After collecting over $1 billion in reinsurance premiums from companies that relied on the 'boosted' surplus—and long before claims from the business are paid—PMA Capital Corporation is saying…we would like to 'unstack' [and] strip PMA Insurance Group from PMA Capital Insurance Company…We and others relied on that boosted surplus, as PMA Re intended us to do." Miller was skeptical of Keefe, Bruyette's opinion. "Saying PMA Capital Insurance Company will not be statutorily insolvent after the proposed transaction means little. There is no opinion that [it] will not later become insolvent, and that is the concern." Miller suggested that PMA Capital Corporation guarantee that PMA Re's surplus would not go below zero.

PMA's Hitselberger, in his signature quip found in most responses, told Miller that "your letter raises mere conjectures about the future that are not a sufficient basis to disapprove the unstacking."

Markel Corporation also objected to the restructuring. Joseph M. Donley, a partner at the law firm Kittredge, Donley, Elson, Fullem, & Embick, wrote a nine-page letter on its behalf. He said that "Keefe's opinion is of a very limited scope," and expressed the desire for "an outside opinion on whether or not the substantial decrease in PMA Re's surplus arising from the transaction [would] impact [PMA Re's] ability

Companies Opposing PMA

Insurance companies that wrote to the Pennsylvania Department of Insurance in opposition to PMA Capital Insurance Company's proposed "unstacking."

Acceptance Insurance Company
ACE American Insurance Company
Acuity Insurance Company
American Home Assurance Company*
American Resources Insurance Company, Inc

American Safety Insurance
Atlantic American Corporation
Baldwin & Lyons, Inc.
Benfield Inc.
Chubb Group of Insurance Companies

Discover Reinsurance Company
Federated Mutual Insurance Company
Florida Workers' Compensation Joint Underwriting Association
ICW Group
GAINSCO, INC.

Liberty Mutual
Mag Mutual Insurance Company
Markel Corporation
McM Corporation
Medical Mutual Liability Insurance Society of Maryland

National Union Fire Insurance Company of Pittsburgh, Pennsylvania*
Nationwide
New Jersey Physicians United Reciprocal Exchange
NORCAL Mutual Insurance Company
QBE Reinsurance Company

Scottsdale Insurance Group
Sentry Insurance Company
Service Insurance Company
St. Paul Travelers
T.H.E Insurance Company

Western National Insurance Group
Workers Compensation Reinsurance Bureau

** Appealed the Insurance Department's decision to permit the unstacking.*

to fulfill its current obligations to its reinsureds." He concluded by saying that "this type of financial manipulation of a subsidiary or affiliate for the benefit of the parent, which further places the manipulated affiliate in a weakened financial condition, rings of Enron. Who stands to suffer? The policyholders/reinsureds, employees, and creditors."

In his reply, Hitselberger said that Donley's invocation of Enron "demonstrate[s] that Markel will simply go to any length to attempt to discredit [the] unstacking application."

The unstacking application was supported by a number of agents and brokers that had relationships with the PMA Insurance Group, which was likely to benefit as a direct subsidiary of PMA Capital Corporation. Perhaps the most unusual letter was from Geoffrey Adamson of Goldman Sachs' Special Situations Investing, who offered his support for the unstacking and said he was addressing the issue "as it pertains to the capital markets." Adamson said that the unstacking "would be beneficial both if PMA Re and the primary pool companies are adequately capitalized and also if they are not adequately capitalized," and that the unstacking would provide "a boost to the confidence levels of the capital markets participants towards PMA Capital Corporation's future success." Adamson's letter did not disclose that Goldman Sachs owned 2.92% of PMA Capital Corporation, almost all of which was bought after the stock collapsed in November 2003. Since the unstacking would transfer $300 million from PMA Re to PMA Capital Corporation, the company's shareholders would be the primary beneficiary of the transaction.

The Insurance Department did not hold hearings about the unstacking, and whatever process it used to arrive at a decision was not made public. On June 25, 2004, Pennsylvania's Deputy Commissioner of Insurance, Stephen J. Johnson, approved the unstacking application. His brief decision said that the Department had considered "all of the comments as well as PMA's responses to those comments." The points raised by many of the objections were not discussed in the decision.

Johnson's decision was appealed by two AIG companies, American Home and National Union, which alleged that they had not been provided with due process because they hadn't learned of the proposal until about June 1, several days after the deadline. Commissioner Diane Koken denied their appeal.

In August 2004, a little over a month after the unstacking was approved, A.M. Best downgraded PMA Capital Insurance Company to B+. In November, A.M. Best upgraded the PMA Insurance Group, now directly owned by PMA Capital Corporation, to A-. During the first nine months of 2005, PMA Capital Insurance Company increased its reserves by $30 million.

PMA Capital Insurance Company will be in runoff for ages. Whether its liabilities will be paid in full will not be known for many years. All of which serves as a reminder that financial strength is not always what it appears to be. An insurance company can become weak by removing assets, as PMA did. It would be wise to take this difficult-to-quantify risk into consideration when buying insurance or reinsurance.