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The Insurance Company Stock-Option Bazaar

CEOs Get Cheap Options

Stock options may be a good form of compensation for start-up companies, but they aren't appropriate for CEOs at most insurance companies.

From a shareholder's perspective, they have several drawbacks. They don't align the CEO's interests with those of shareholders. Shareholders can make or lose money on a stock, but a CEO can only make money on stock options. Options—as opposed to stock—provide an *incentive* for a CEO to take greater risk than he might otherwise, since he has no downside. Owning stock instead of options makes a CEO think like a shareholder. (Shareholders consider risk versus reward; an option holder thinks more about reward since there is no risk.)

Although stock options are often granted under "incentive" plans, they usually aren't incentives—they are bonuses. A 10-year option to purchase stock at a fixed price is almost certain to provide a payoff. Even poor stock performance can produce significant compensation. The amount of money a CEO ultimately receives from options is somewhat arbitrary, since stock prices don't necessarily reflect the underlying performance or intrinsic value of the company.

At one time, stock options were not common, but in the last couple of decades their use has exploded. We won't focus on the largest compensation packages, such as that received by Sandy Weill. Weill, for instance, has received options, bonuses, and more options worth more than $1 billion. After Citicorp and Travelers merged, for example, Weill was granted—in addition to his huge pay package—1,750,000 *additional* options worth $16.9 million for the role he supposedly played as a "founder" of Citigroup. (Tell that to Weill's predecessors, among them Walter Wriston of First National City Bank, James Stillman of National City Bank, and George F. Baker of First National Bank.)

Instead of examining the most oversized pay packages, let's look at a less obvious practice: granting CEOs stock options at strike prices far below true value.

In order to avoid being considered ordinary income at the time of issuance, stock options are generally issued at "fair market value": usually the stock price on the date of issue. Sometimes the stock price really represents "fair" market value, but often it does not. The stock market is volatile, and stocks frequently trade at significant discounts to their actual value. This was especially true last year.

Take IPC Holdings, parent of IPC Re, a Bermuda catastrophe reinsurer. On January 3, 2000, CEO James Bryce received 17,000 ten-year options to purchase stock at $15.375 per share. At that moment IPC's book value was $19.42, and the company looked more like a high-quality short-term bond fund than an insurance company: shareholders' equity was $504 million versus written premiums of $97 million. IPC, which had only 13 employees, could have *liquidated* itself for more than $21 per share. Granting options below book value diluted shareholders' equity, and was a bonus rather than an incentive.

We've compiled a list of insurance companies that engaged in this type of stock-option issuance last year. Some examples are described below. (We haven't attempted to catch all perpetrators, and would be glad to hear from

Free Money: Insurance-Company CEOs Clean Up on Cheap Stock Options

During 2000, the CEOs of these companies received stock options at bargain-basement prices—below book value in all but two instances. This chart shows the exercise price of the options granted, the book value at the time of the grant, today's stock price, and the CEO's profit per share (to date) from the options grant. Since the options are issued for 10 years, most CEOs will reap much greater profits over time.

Company	Book Value	Option Price	Current Stock Price	CEO's Profit Per Share
American Financial Group	$26.37	$19.84	$27.76	$7.92
AmerUs	$25.36	$20.00	$34.89	$14.89
W. R. Berkley	$23.00	$15.50	$38.40	$22.90
Cincinnati Financial	$31.18	$29.72	$40.75	$11.03
Harleysville Group	$18.29	$16.48	$26.85	$10.37
Investors Title	$14.20	$12.44	$15.05	$2.61
IPC Holdings	$19.42	$15.38	$22.60	$7.23
Loews (CNA)	$47.75	$30.14	$70.35	$40.21
Midland (American Modern)	$27.11	$22.75	$36.85	$14.10
PXRE	$22.54	$12.50	$17.71	$5.21
RLI	$29.68	$31.90	$41.54	$9.64
St. Paul	$28.68	$29.31	$49.57	$20.26

readers who have noticed other examples of egregious behavior.)

On January 31, 2000, The St. Paul Companies issued 202,902 ten-year options, with an exercise price of $29.31, to chairman, president and CEO Douglas Leatherdale. St. Paul's stock was depressed and trading slightly above its book value of $28.68. St. Paul clearly thought its stock was extremely undervalued at this price: in 1997, 1998, and 1999 it spent $619 million to repurchase shares at average prices of $37.64, $35.52, and $32, respectively.

Investors Title is a well-run company headquartered in Chapel Hill. Last year, the three senior officers—J. Allen Fine (who controls the company) and his two sons—were each granted 50,000 options at an average price of $12.44. Investors Title's book value was then $14.20, and the company's intrinsic value was well above that. On the same date as the stock-option grant, the Fines authorized a 500,000-share buyback program.

Investors Title then spent $2.1 million—two-thirds of its earnings—repurchasing 175,175 shares at an average price of $12.01. But it *granted* 212,500 stock options at an average price of $12.07. Because of the option grants, shareholders won't benefit from the share repurchase.

Over at Loews Corporation, which owns CNA, the second generation of Tisches (James, Andrew, and Jonathan), who now run the company and whose families own $4 billion of Loews stock, each received 20,000 stock options at $30.14 per share, a price equal to 57% of book value. Loews also believed that its stock was significantly undervalued when the options were issued. During the past three years it has spent $1.2 billion on share repurchases, with the bulk of the repurchases at prices much higher than the stock-option grants.

AmerUs, which converted from a mutual to a mutual insurance holding company in 1996, has a history of favoring its CEO over its policyholders. AmerUs Group, the public subsidiary, has a history of favoring its CEO over its shareholders. On February 11, 2000, Roger Brooks, chairman and CEO of AmerUs Group (then controlled by the mutual insurance holding company), received a massive gift from his relatively small company: 195,000 ten-year options with an exercise price of $20. (His options accounted for 32% of all options granted to AmerUs employees.) At the time of the grant, AmerUs's stock was near its low, in part because of the mutual-holding-company structure. Still, book value was $25.36, and the company had repurchased shares at prices above that. Brooks has already hit the jackpot on his options: AmerUs's stock is now $34.89, giving him a $2.9 million profit—and his options still have nine years left to run.

Between 1998 and 2000, W.R. Berkley spent $147 million to buy back shares at an average price of $29.76. Last year, William R. Berkley, chairman, CEO, and owner of approximately 4,000,000 shares (13.9% of the company), was granted 70,000 ten-year options to purchase shares at $15.50. At that time book value was about $23 per share, and intrinsic value was at least $30 per share. (The stock is now $38.40.)

We talked with Berkley, who, for our money, has one of the most rational, incisive minds in the insurance industry. "If you grant stock options below market value, they don't serve as an incentive," he said, adding that "the tax laws are written in a way that precludes you from granting options in a format that makes sense." A better incentive would be to have options issued—and cashed out—at book value, suggested Berkley, the idea being that growth in book value is relevant to shareholders, and a reasonable proxy for growth in enterprise value.

"Do option plans, as now constituted, represent a good incentive?" Berkley mused. "Sometimes yes and sometimes no." He noted that because of accounting rules, the payment of cash compensation reduces reported earnings (and, of course, book value), while the issuance of options does not.

There's no correlation between stock options and success. Berkshire Hathaway doesn't grant options. Neither does Markel Corporation. Markel's employees (but not senior management), can borrow money from the company to purchase shares in the open market.

We now vote against all stock-option plans, and vote against the directors of those companies, as well. Right now, this protest is just a tiny voice in the wind. But perhaps over time, shareholders will wake up and demand rational compensation and real incentives.

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