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# SCHIFF'S INSURANCE OBSERVER

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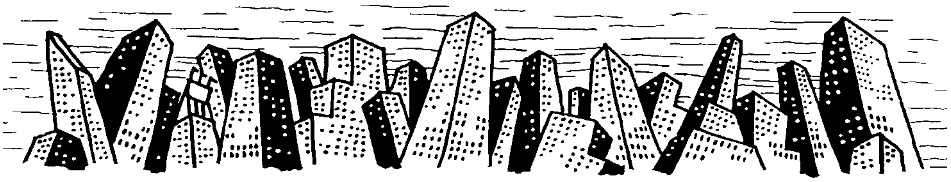

## THE INSURANCE BEAT

### Lumbermens' Surplus Notes

IN OUR DECEMBER 31 issue ("Disaster at Lumbermens and Kemper") we said that Lumbermens Mutual Casualty Company was in deep trouble and opined that the Illinois insurance commissioner would not permit the company to make interest payments on its surplus notes. (Although surplus notes are debt, statutory accounting treats them as equity. Surplus notes are subordinated to all policyholder liabilities, and interest and principal payments can be made only with the prior approval of the commissioner after he determines that the financial condition of the insurance company warrants the making of such payment.)

We were wrong about one thing: outgoing commissioner Nathaniel Shapo *did not* prevent the company from making an $18-million interest payment to its surplus-note holders on January 1.

We were not wrong, however, about Lumbermens' troubled financial condition. On March 20, Lumbermens received notice from acting insurance commissioner, Arnold Dutcher, that its request to make $30,825,000 in interest payments due June 1 and July 1 on its $700 million of surplus notes had been denied. The surplus notes, which traded at 55 in mid-December and 40 at year-end, were in the vicinity of 6 at that time. (The market for ultra-distressed surplus notes is thin, at best.)

Lumbermens apparently felt no need to break the bad news immediately. When it made the news public five days later on March 25, it also announced a consent solicitation and a cash tender offer for the surplus notes, offering to pay $10 for each $1,000 of face value. The purposes of the tender offer and consent solicitation are to retire the notes and amend a covenant that might restrict the "sale, conveyance, transfer, lease or other disposition of all or substantially all of Lumbermens' assets." Tendering noteholders must consent not to sue Lumbermens or its affiliates, subsidiaries, attorneys, financial advisors, past and present directors, officers, trustees, employees, and so on.

Lumbermens intends to sell most of what's left of its organization—several insurance-company subsidiaries, renewal and expiration rights, and the use of the "Kemper" name—to an investment group affiliated with Swiss Re. Without a successful tender offer and consent solicitation, the deal will not happen. (It may not happen anyway.)

The Lumbermens debacle raises many questions, some of which we will list. Why did insureds buy insurance from an obviously weaker insurance company whose ability to pay claims was far less certain than that of stronger companies offering similar coverage, albeit at prices that might have been a bit higher? Why did the insurance commissioner permit Lumbermens, a troubled company, to pay $30.82 million of surplus-note interest between December 1, 2002 and January 1, 2003? If the commissioner and the insurance department permitted the payments because they believed that denying them would send Lumbermens into a death spiral, what effect will that have upon other commissioners who must approve or deny interest and principal payments on approximately $25 billion of outstanding surplus notes? Will commissioners become more proactive in the future and refuse to allow weaker insurance companies—those rated lower than "A-", for example, or those whose surplus notes are rated "BBB" or lower—to make interest or principal payments? If regulators become more proactive, will that hasten the demise of weaker companies that have issued surplus notes? Will regulators pay greater attention to the payment of dividends by weaker insurance companies?

Finally, what is one to make of Lumbermens' recently filed annual statement, which shows $696.8 million of surplus (making no deduction for the $700 million of surplus notes) as of December 31, 2002? If that surplus is, in fact, real, why should a noteholder tender for ten cents on the dollar?

Of course, Lumbermens' financial statements haven't been right in the past. Why should the present and the future be any different?

### Investment Considerations

ON NOVEMBER 18, 1997—just another day in the long, soft insurance market—Goldman, Sachs and Lehman Brothers raised $300 million for Lumbermens Mutual via the sale of two issues of surplus notes to "qualified institutional buyers." The first issue matured in forty years and carried an 8.3% coupon. The second issue matured in 100 years and carried an 8.45% coupon. Both issues will default, and both are almost worthless.

The offering circular for the notes included the following factors that "investors should consider carefully": 1) regulatory restrictions on the payment of interest and principal, 2) the notes' subordination to policyholders' liabilities, 3) the uncertainty regarding the adequacy of property-casualty loss reserves, 4) competition, 5) the fluctuation of insurance-industry results, 6) Lumbermens' mutual company structure, and, 7) the "millennium" issue. (Remember that?)

Lumbermens' "strategic growth initiatives" were not listed as an "investment consideration" or risk factor. The "growth initiatives," unfortunately, were the "use of proceeds."

## Free Money—Almost

ONE SOMETIMES WONDERS why insurance companies—which, after all, invest a lot of money—are so often out of synch with the securities markets. In recent years, for example, mutuals such as MetLife, John Hancock, and Principal issued stock at distressed prices and then bought it back at much higher prices. In contrast, Allstate and Chubb did not issue more stock when their shares were hitting all-time highs. They bought back stock instead.

W.R. Berkley, Markel Corporation, and—yes—Fairfax, played the game right: when their stocks went way up, they issued new shares, increasing shareholder value. Baldwin & Lyons did it right, too: it repurchased its shares when they were at a discount to book value.

HCC Insurance Holdings has also played the capital markets well. On March 6, 2001, it raised $152 million in a public offering of its shares at $23.25, a price equal to 220% of book value. On March 26, 2003, it announced the sale of $125 million of convertible notes maturing in 2023. The notes pay the whopping interest rate of 1.3% per annum and are convertible at $33.97 per share—a 35% premium to HCC's current stock price.

So skimpy an interest rate is 1.3% that one wonders who would buy such a security. An HCC bull would, presumably, buy the stock (which yields 1%) instead. And a bear, one supposes, would want nothing to do with the stock or the notes. Whatever the case, we tip our hat to HCC's canny chairman and CEO, Stephen Way, who espoused his views on capital preservation at the *Schiff's Insurance Conference* last year.

## Junk Surplus Notes

IF THE PRICE OF AN INSURANCE company's surplus notes is a leading indicator, then the venerable Atlantic Mutual, rated "A-" by Best, is a company in deep trouble. Its 8.15% surplus notes of 2028, of which $100 million are outstanding, were recently quoted at 66, offering a yield to maturity of 12.68%, which works out to a 775-basis-point spread over Treasurys. In comparison, Nationwide Mutual's surplus notes trade at a 295-basis-point spread to Treasurys.

## AIG's Deceptive Mailing

AIG IS, AMONG OTHER THINGS, a direct writer of personal auto insurance. Its recent direct-mail campaign targeted to good drivers touted the possibility of "a quote that's hundreds of dollars less" than Allstate, GEICO, or State Farm.

"If you can't believe there's any company out there that's offering better rates," AIG's letter said, "then take a close look at what we've been quoting our new policyholders...An average of $393.14 less than Allstate...$373.76 less than GEICO...$274.84 less than State Farm...and $295.12 less than a long list of other companies. Those are documented average annual savings reported by our new policyholders."

We assume that AIG's statements are accurate. The insurance marketplace is inefficient, and good drivers can often obtain significant savings by switching carriers. On the second page of its letter, AIG provides a long list of potential discounts that could reduce premiums even more.

Then, to allay sales resistance, the letter goes too far: "And, if you're concerned about getting a quote from a company you've never been insured with, don't be. You'll be taking a step up in service and reliability!"

The letter states that AIG's member companies "have earned the highest possible ratings for financial strength and *reliability*." [Emphasis added.] As proof of this statement, the letter cites AIG's "A++" Best rating and "AAA" S&P rating.

AIG's statement is false, however. Rating agencies don't rate insurance companies for "reliability;" they rate them for *financial strength*. Consumers, of course, are extremely concerned about reliability—whether their coverage will be cancelled, whether their rates will go up, whether a claim will be paid. Financial-strength ratings offer no guidance in those areas.

In an flyer accompanying the letter, AIG once again misleads its prospects. After saying "don't be surprised if our quote turns out to be 25% less than you're paying now," AIG states the following in bold letters: "And no insurance company is rated higher for *stability* and operating performance by A.M. Best...than members of American International Group, Inc." [Emphasis added.]

Best's ratings are an opinion of an insurance company's financial strength and ability to meet ongoing obligations to policyholders. Financial strength rat-


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ings are assigned after Best has analyzed an insurance company's balance sheet strength, operating performance, and business profile.

AIG does not have the highest rating for "stability and operating performance" from Best or anyone else. No such rating exists.

AIG's claims that it has the highest ratings for "reliability" and "stability" are false and deceptive. The company should correct its marketing material. ■

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