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## **INSURANCE AND FINANCIAL SERVICES REPORT**

### **ENRON'S MELTDOWN HITS THE INSURANCE AND BANKING SECTORS**

On December 2, 2001, Enron Corporation filed for Chapter 11 bankruptcy protection — the largest bankruptcy filing in U.S. history. The announcement was the culmination of a spectacular collapse in the value of Enron's common stock which was trading at \$84 per share within the past year but plummeted below \$1 per share in December. As of September 30, 2001, Enron had reported consolidated assets of \$61.7 billion and shareholders equity of \$9.6 billion. The collapse of Enron has had a direct impact on insurance companies and other financial institutions and is likely to result in new SEC regulations concerning the disclosure of financing transactions between issuers and special purpose entities.

Enron's demise was precipitated by a number of public disclosures regarding its financial practices. On October 16, 2001 Enron announced that it had recorded a \$1.01 billion after-tax charge to its third-quarter earnings to recognize asset impairments, restructuring costs, and losses associated with certain investments. On October 17, 2001, the Securities and Exchange Commission requested that Enron supply information concerning certain related party transactions and on October 31, 2001, the SEC opened a formal investigation. Congress has also begun several investigations of the collapse.

On November 8, 2001, Enron announced its intention to restate its financial statements for the year ended December 31, 1997 through 2000 and the quarters ended March 31 and June 30, 2001, reducing previously reported income for the past four and a half years by \$569 million, or 16% of reported net income for the four and a half year period. One of the major reasons for the restatement was the conclusion that three previously unconsolidated entities — Chewco Investments, L.P. ("Chewco"), Joint Energy Develop-

ment Investments Limited Partnership ("JEDI") and LJM Cayman, LP ("LJMI") — should have been consolidated into Enron's financial statements. Enron's level of disclosure of material transactions involving these and other special purpose entities was widely criticized by investment analysts and others.

On November 19, 2001 Enron reported a loss of \$644 million for the third quarter of 2001. Enron also made more detailed disclosures as to a variety of other transactions using special purpose entities that often involved related parties. For example, in connection with its capitalization of four special purpose entities known as Raptor I-IV, Enron issued common stock in exchange for a note receivable. Enron increased notes receivable and shareholders' equity to reflect this transaction. In the first quarter of 2001, Enron entered into a series of transactions that could have obligated Enron to issue common stock in the future in exchange for notes receivable. Enron concluded in its November 19th SEC filing that its accounting for these transactions was not correct under generally accepted accounting principles and overstated equity and notes receivable by \$1 billion in its unaudited balance sheets of March 31, 2001 and June 30, 2001.

On November 19, 2001, Enron also disclosed that a note payable in the amount of \$690 million related to a limited partnership had been accelerated due to a downgrade in Enron's debt rating. On November 28, 2001, several rating agencies further lowered Enron's long-term debt to below investment grade. This, in turn, caused the acceleration of other debt instruments.

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Shortly after the downgrades, Dynegy Inc. terminated its proposed merger with Enron and Enron filed for bankruptcy on December 2nd.

Standard & Poor's estimates that the exposure of U.S. insurers' investment portfolios to securities issued by Enron and its affiliates is more than \$3.5 billion. S&P estimates that \$2.6 billion of the exposure is with life insurance companies. The exact amount of the current exposure is difficult to determine because a number of insurers sold their Enron securities prior to the December 2nd bankruptcy or their most recent reporting periods. Both Standard & Poor's and Moody's Investors Service currently do not believe that these losses on Enron securities are likely to have an effect on life insurers' ratings.

A number of insurance companies have announced their loss exposures as a result of owning Enron securities or debt obligations. John Hancock Life Insurance Company reported a net investment exposure of \$320 million. Aegon announced that its gross loan exposure to Enron and affiliated entities amounted to about \$300 million. AXA Group has an exposure in Enron fixed debt securities of about \$180 million. Hartford Financial Services Group announced that it had Enron-related securities in its portfolio with a net carrying value of approximately \$92 million. Hartford expects that it will record an after-tax realized capital loss of \$40 million in the fourth quarter of 2001.

Property and casualty insurers have exposure to Enron relating to surety bonds and other insurance policies issued in Enron-related transactions. To date, insurers have announced an exposure of about \$700 million relating to surety bonds. The surety bonds make payments on financial contracts in the event of a default. Chubb Corp stated that it had \$220 million in maximum pre-tax exposure to surety bonds relating to Enron. Swiss Re has estimated loss exposure of \$173 million before tax, including surety insurance exposure, its corporate bond portfolio and its credit default swaps portfolio.

XL Capital, Ltd., a Bermuda-based insurer, has reported an exposure of \$75 million, including \$45 million attributable to surety bonds. Hartford has exposure with respect to insurance coverage of about \$20 million after taxes and net of reinsurance. The exposure arises from surety bonds, directors and officers insurance and assumed reinsurance. SAFECO has reported that its pre-

tax operating income will be cut by \$20 million as a result of surety bonds issued to Enron.

St. Paul Companies has reported that its aggregate limits of Enron-related insurance exposure, net of reinsurance and calculated on an after-tax basis, is \$85 million. The maximum insurance exposures consist of surety bonds, including gas supply bonds, financial guarantees and standard construction bonds as well as surety reinsurance and directors' and officers' liability insurance. CNA Surety announced a pre-tax exposure, net of reinsurance, of \$8 million under outstanding surety bonds issued in connection with Enron contractual obligations.

According to S&P, Enron was included in 50 transactions as a reference entity or reference obligation in pooled credit derivative transactions — meaning that counterparties have Enron credit exposure. Direct Enron credit exposure potentially could total \$3.3 billion.

Some banks have large exposures. J.P. Morgan Chase announced that it had an aggregate exposure in excess of \$2.3 billion, including unsecured exposure relating to loans, letters of credit and trading activity of about \$620 million and secured loan and trading exposure of about \$600 million. In December, JP Morgan Chase filed suit against eleven insurance companies seeking payment under Enron-related surety bonds. The surety contracts were issued by the insurance companies to guarantee obligations of Enron North America Corporation and Enron Natural Gas Marketing Corporation under prepaid forward natural gas and crude oil contracts. At issue in the case is approximately \$1.1 billion, of which JP Morgan Chase's share is approximately \$965 million. J.P. Morgan has stated that its difficulty in recovering on the surety bonds may cause it to re-think its willingness to accept surety bonds as credit support in financial transactions.

Enron's bankruptcy has caused the SEC and Congress to begin to take a close look at the accounting for special purpose entities, such as Chewco, JEDI and LJM1. Special purpose entities ("SPEs") are typically created by a sponsor to carry out a special purpose or activity. They are typically used as an off-balance sheet financing mechanism in which assets are sold to a trust, partnership or other entity controlled by an unrelated party in exchange for cash or other assets funded by debt issued by the trust or entity. Most SPE transactions are designed to be off-balance sheet so that the

assets and liabilities of the SPE are not consolidated with the financial statements of the transferor.

In order to achieve off-balance sheet treatment under generally accepted accounting principles, two requirements must be met. First, the asset must be sold to the special purpose entity in a manner so that the assets are legally isolated from the transferor. Secondly, an independent third party owner that has made a substantial capital investment (which amounts to at least 3% of the SPE's total assets) must control the SPE and truly possess the substantive risks and rewards of owning the SPE's assets. The equity must be "at risk" from the investor's perspective. If the investor's return is not at risk due to guarantees or other financial support by the transferor or the transferor controls the SPE, the transferor should consolidate the SPE in its GAAP financial statements.

A number of the Enron transactions raise substantial questions as to whether these GAAP accounting requirements were complied with. Enron is believed to have several hundred SPEs.

Because SPEs are widely used as financing mechanisms in many transactions by public companies, it can be expected that the SEC will, at a minimum, require much more detailed disclosure concerning such entities. Already, the SEC has announced it will consider new rules to elicit more precise disclosure about the accounting policies that management believes are "most critical" to the portrayal of a company's financial results and financial condition. In SEC Release No 33-8040 issued December 12, 2001, entitled "Cautionary Advice Regarding Disclosure About Critical Accounting Policies" the SEC stated: "Even before new rules are considered, however, we believe it is appropriate to alert companies to the need for greater investor awareness of the sensitivity of financial statements to the methods, assumptions and estimates underlying their preparation. We encourage public companies to include in their MDA [Management, Discussion and Analysis] this year full explanation, in plain English, of their "critical accounting policies," the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions."

The SEC also stated that public companies should employ a "disclosure regimen" along the following

lines: (1) Each company's management and auditors should bring particular focus to the evaluation of the critical accounting policies used in the financial statements. (2) Management should ensure that disclosure in MDA is balanced and fully responsive. (3) Prior to finalizing and filing annual reports, audit committees should review the selection, application and disclosure of critical accounting policies. (4) If companies, management, audit committees or auditors are uncertain about the application of specific GAAP principles, they should consult with the SEC's accounting staff.

In short, as a result of the Enron collapse, it can be expected that companies which use SPEs will be required to make more detailed disclosure and off-balance sheet entities will be more closely scrutinized. The use of surety bonds in financing transactions will also be more carefully studied.

## **FUNDING AGREEMENT-BACKED NOTES COME OF AGE**

**By  
Bruce Ballentine  
Director — Credit Research  
ABN AMRO**

### **Highlights**

- The notes are secured by funding agreements ("FAs") of highly rated US life insurers.
- Issuance has soared from just USD 700 million in 1997 to USD 28 billion in 2001 under programs established by some 15 insurers.
- Issuers are flexible as to currency, maturity, coupon and deal size, selling notes into Europe, Asia, Australia and the US.
- Notes are issued through a special purpose vehicle ("SPV") that invests the proceeds of each issue in a matching FA of the sponsoring insurer.
- FAs rank pari passu with policyholder claims, such that note ratings match the insurance financial strengths of the insurer.
- FAs are regarded as operating leverage, not financial leverage, on the books of the insurer.
- Despite the robust market growth, FA-backed notes amount to less than one-tenth of consolidated assets for most sponsoring firms.

- The US life & health insurance sector is alive and well, achieving consistent profits and growth over the past decade.
- Life insurance rating outlooks from Moody's Investors Service ("Moody's") and Standard & Poor's ("S&P") are stable.

### Dramatic growth

FA-backed notes were developed in the mid-1990s, and issuance has soared from USD 700 million in 1997 to USD 28 billion in 2001, according to S&P. (See Exhibit 1.) Aggregate issuance is approximately USD 70 billion, under programs sponsored by some 15 different firms. The dollar amount authorized under these programs now exceeds USD 100 billion. Additional programs may be established by insurers with high credit ratings and with expertise in institutional spread business.

For investors, this market offers a wide range of currencies, coupons and maturities backed by a diverse group of highly rated insurers. At present, the S&P ratings on FA-backed notes are all AA- or higher, and the Moody's ratings are A1 or higher. (See Exhibit 6.)

For US life insurers, the market offers a large volume of institutional funding to augment the companies' asset accumulation activities. Using established investment and asset/liability management skills, the insurers can generate positive spreads typically in the range of 50-100 basis points per annum (pretax) on this funding.

**Exhibit 1**

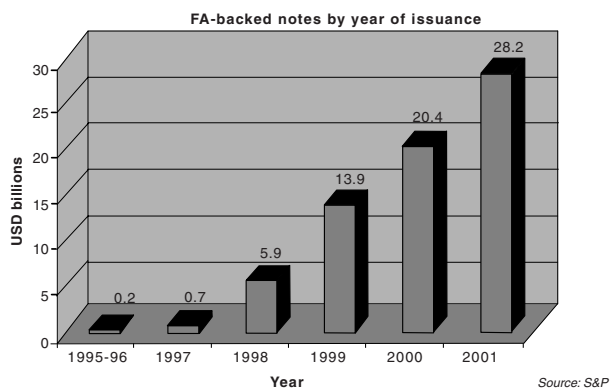
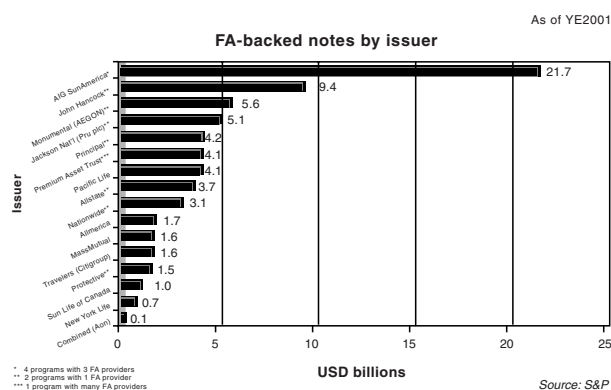


Exhibit 2 shows FA-backed note program sponsors ranked by dollar amounts issued. The SunAmerica arm of American International Group Inc. ("AIG SunAmerica") is the inventor of the product and the

largest sponsor, with USD 22 billion of notes issued through four separate programs. When AIG acquired SunAmerica at the start of 1999, the company's FA-backed note programs adopted the AIG SunAmerica name and were upgraded to "Aaa/AAA" from "NR/AA-", facilitating greater issuance.

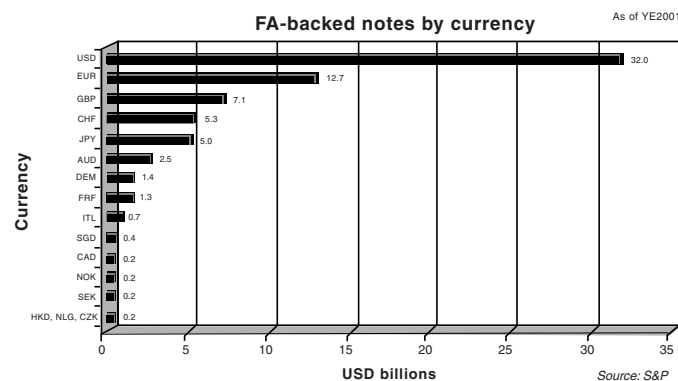
The next largest program sponsor is John Hancock Life Insurance Company ("John Hancock"), raising USD 9 billion through two programs. Several other insurers have raised multiple USD billions through FA-backed notes.

**Exhibit 2**

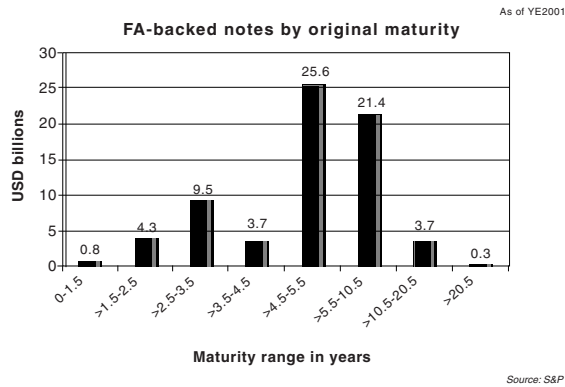


As shown in Exhibits 3 and 4, FA-backed notes come in a variety of currencies and maturities. Notes have been issued in more than a dozen currencies, led by US dollars, Euros, British pounds, Swiss francs and Japanese yen. Original maturities on large issues are concentrated around three, five, seven and 10 years, while on small issues they range from one to more than 20 years. Coupons can be fixed, floating, zero, or linked to an equity or other market index. The S&P data reflect several hundred large and small note issues.

**Exhibit 3**



## Exhibit 4



**Distribution goes “global”:** In the early years, nearly all FA-backed notes were issued under Euro-MTN programs and sold to investors in Europe, Asia and Australia. Issuers and dealers avoided US distribution because they were wary that US insurance regulators might regard an FA-backed note as an interest in an insurance contract and, therefore, subject to insurance regulation. This interpretation would have meant that such notes could be sold in the US only by insurance agents or brokers, not by investment sales representatives.

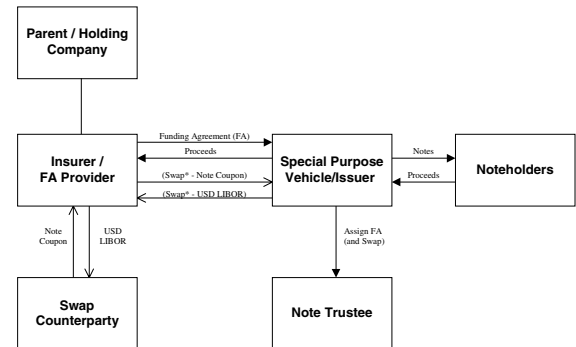
Through discussions with regulators and through legal research, leading issuers and dealers eventually determined to their satisfaction that FA-backed notes are investment products, not insurance. In April 2000, AIG SunAmerica launched the first large “global” issue of FA-backed notes, available to general investors outside the US and to institutional investors within the US under Rule 144A. Since then, similar global programs have been established by six other insurers: John Hancock, Allstate Life Insurance Company (“Allstate Life”), Monumental Life Insurance Company, Principal Life Insurance Company, Nationwide Life Insurance Company and Jackson National Life Insurance Company. Through 2001, these companies raised a total of about USD 17 billion in the global format.

The US is a large alternative source of funds for these insurers and a market where their names are already well known. However, because of more stringent US securities laws, documentation costs are higher for global deals than for pure Euro deals. Therefore, the insurers with global programs maintain their capacity for pure Euro issues as well, either through separate programs or, in the case of John Hancock, through one multi-purpose program. The Euro format is generally used for issues sold entirely to non-US

investors, whereas the global format is used for issues sold partly or fully to US investors.

## Program structure

### Exhibit 5



\* In most programs, the FA is issued in the same currency and coupon as the notes, so there is no swap with the SPV.

The typical structure of an FA-backed note program is shown in Exhibit 5. The issuer is an SPV set up exclusively to issue notes secured by FAs of the sponsoring insurer. An FA is a direct senior obligation of an insurance company. The SPV issues a series of notes in a given currency, coupon and maturity, and it purchases a matching FA from the insurer, such that the cash flows from the FA cover all amounts due under that series of notes. The FA is pledged to the note trustee as collateral for the notes.

When notes are issued in currencies other than USD, the insurer generally converts its obligations to USD LIBOR. In most programs, the insurer provides an FA in the same currency and coupon as the notes. The insurer then enters into a swap with an unrelated counterparty, but there is no swap involving the SPV. At least two insurers — AIG SunAmerica and John Hancock — take a different approach, providing FAs strictly in USD. Under this approach, the insurer enters into a swap with the SPV such that the FA and swap together provide cash flows to cover the note obligations. The insurer can then complete a swap with an unrelated counterparty to convert its ultimate obligation to USD LIBOR.

FA-backed notes are not guaranteed by the FA provider nor by any other party. Instead, the credit quality lies in the security interest that investors have in the FAs backing the notes. Investors, therefore, should consider the credit strength of the FA provider and of its overall group when buying such notes.

**Nature and purpose of SPV:** For a pure Euro program, the SPV is typically a limited liability company based in the Cayman Islands or Channel Islands. For a global program, the SPV is either a business trust or a limited liability company based in the State of Delaware. Some insurers use a separate Delaware trust for each global issue. Certain of the Delaware SPVs have issued small amounts of subordinated paper to bolster the accounting argument that the Delaware entity should not be consolidated with the sponsoring insurer under GAAP. In particular, Delaware SPVs sponsored by AIG SunAmerica and by Allstate Life have issued subordinated auction market securities amounting to at least 3% of the obligations of the respective SPVs. The auction market issues are secured by FAs but are junior to all FA-backed notes.

In both Euro and global programs, the SPV is needed to convert a non-tradeable insurance contract (the FA) into tradeable investment products (the notes). The insurer does not issue FAs directly to capital market investors because an FA is written for a specific holder and is generally not transferable. The insurer does not issue notes directly to investors because US insurance regulators would likely frown upon the use of “debt” or “borrowed money” to fund an ongoing spread business.

SPVs of this sort have been used in asset backed markets for many years. The SPV must safeguard a set of assets — FAs in this case — for the benefit of investors. S&P has published a report on its SPV rating criteria, which include the following:

- Restrictions on objects and powers;
- Debt limitations;
- Independent director or general partner charged with looking after interests of creditors;
- No merger or reorganisation;
- Separateness covenants;
- Security interests over assets.

### **Funding agreements**

An FA is a direct senior obligation of an insurance company, created under and governed by insurance laws and regulations. It is a simple contract, like a promissory note, spelling out basic terms such as principal amount, interest rate and maturity of the obligation. The FA wording and regulatory treatment can

vary from state to state, because insurance is regulated by separate insurance departments of the 50 states. FAs are governed by laws of the home state of the relevant insurer, whereas the notes, like most US corporate securities, are ordinarily governed by New York law.

**Pari passu with policyholder claims:** For all existing programs, FAs are deemed to rank pari passu with policyholder claims of the FA provider, based either on explicit laws of the insurer’s home state or on legal opinions drawn from relevant laws and regulations. This topic is invariably discussed in program documents. The structure, therefore, transfers the credit quality of a policyholder claim at the insurance company to the notes of the SPV. In all cases where notes have been rated by Moody’s and/or S&P, the note ratings match the insurance financial strength ratings of the FA provider.

During the life of this product, at least five states have changed their insurance laws to clarify that FAs rank pari passu with policyholder claims. The states and dates are Arizona in July 1995, Michigan in July 1998, Iowa in February 1999 (retroactive to July 1998), Massachusetts in July 2000 (applicable to new and existing FAs), and Tennessee in April 2001 (applicable to new and existing FAs). All of the new laws suggest that insurance regulators are not only aware of the FA-backed note business but supportive as well, so long as the business is managed prudently.

**FAs versus GICs:** FAs and FA-backed notes are often referred to as “GICs” and “GIC-backed notes”, where “GIC” stands for “guaranteed interest contract” or “guaranteed investment contract”. Despite the popular usage, every program that we have examined is secured by FAs, not by GICs. Product definitions can vary by state and by company, but in general, a GIC has a human life, health or employment contingency and is sold to a pension plan, whereas an FA has no such contingency and is more suitable for a pure spread business. In addition to FAs that secure note issuance programs, FAs are also sold directly to money market funds as permitted liquid investments and to municipalities for interim placement of municipal bond proceeds. We believe that the term “GIC” persists in the capital markets simply because it is shorter and catchier to say than “FA” or “funding agreement”.

**Is an FA debt?** Investors sometimes ask if the FAs securing a note program are really debt in disguise,

even though they appear as “deposit funds”, or the like, on an insurance company’s books. We believe that FAs should be regarded as insurance obligations, alongside life insurance and annuity reserves, and not as debt. An important distinction is that FAs are issued by an operating company, with proceeds invested in near-matching assets, whereas debt is usually issued by a holding company, with proceeds invested in the stock of one or more operating companies. As a consequence, FAs are serviced by interest and sales/maturities of the near-matching assets, whereas debt is serviced by operating company profits paid as dividends to the parent company.

Some insurance operating companies — present and former mutual insurers — have issued debt in the form of subordinated surplus notes. These count as statutory surplus in the eyes of regulators, but as debt in GAAP statements and in the eyes of many analysts. Like holding company debt, surplus notes are serviced by profits of the insurance company, not by a matching portfolio of assets.

**Operating leverage versus financial leverage:** We believe that FAs should be considered as a component of operating leverage, along with other insurance obligations, not as debt or financial leverage. Moody’s and S&P share this view. The rating impact of FA-backed notes, therefore, depends upon the level of surplus allocated to the business as well as the level and stability of profits from this business. In contrast, the rating impact of parent company debt depends upon the firm’s overall capital structure (e.g., the ratio of debt and hybrid capital to total capital) as well as the level and stability of overall profits servicing that debt (e.g., interest and fixed charge coverage ratios).

Another rating concern is that institutional spread business, including FA-backed notes, should not become an insurer’s dominant business. It should be an incremental business, sharing in the investment infrastructure of a broader insurance and annuity business. As discussed under “Ratings”, both Moody’s and S&P say that institutional spread business should not exceed about 30% of an insurer’s general account liabilities.

Based on discussions with issuers and rating agencies, we believe that insurers allocate statutory surplus amounting to 3-6% of FAs written in connection with this business. Surplus is needed to absorb the relevant credit, liquidity and duration risks. Several insurers

have said that they assume well diversified credit and liquidity risks, and that they assume minimal duration risk, resulting in fairly steady investment spreads in the range of 50-100 basis points per annum (pretax) over the cost of funds. We believe that this business generates a return on allocated surplus typically in the range of 12-20% (pretax). Financial leverage at the parent company can then boost the return to shareholders from this and other lines of business.

**Insurance defaults & recoveries:** No FA-backed note issuer has defaulted, so we do not have a direct test the product in that event. Some investors are concerned that in a time of stress, insurance regulators might favor individual life insurance policies and annuities over FAs that secure notes held largely by institutional investors.

We can get some guidance in this area through a Moody’s study entitled *Life After Death — Moody’s Examines Life Insurance Insolvency*, published in April 1999. Moody’s looks at defaults and recovery rates on several types of insurance company obligations during the decade 1989-1998. During this period, three insurers from different jurisdictions defaulted on institutional GICs, a sister product to FAs. The defaulters were Executive Life Insurance Company, based in California (1991); Mutual Benefit Life Insurance Company, based in New Jersey (1991); and the US branch of Confederation Life Insurance Company, based in Canada (1994). The three insurers were brought down primarily by aggressive investments in junk bonds, real estate and mortgages.

According to Moody’s, the GICs fared better than corporate bonds in terms of post-default recovery rates (present value of ultimate recoveries as a percentage of par value). The average recovery rate was 82% for the defaulted GICs (based on conservative payout assumptions), versus an average recovery rate of 51% for defaulted senior unsecured bonds. The Moody’s article concludes that institutional GIC recoveries were below those of life insurance policies, which typically received full benefits, but similar to those of individual and group annuities. Recovery rates on such products could vary from state to state, but the limited case history suggests that the recoveries on defaulted FA-backed notes might be lower than on individual life insurance, yet higher than on senior bonds.

## FA-backed note ratings

S&P and Moody's rate FA-backed notes at the request of the sponsoring insurers. For each program that we have seen, ratings on the notes match the insurance financial strength ratings of the FA provider, as shown in Exhibit 6. The rationale is that (i) FAs are pari passu with policyholder claims, and (ii) the SPV transfers the credit quality of the FA to the noteholders.

**Exhibit 6**

Ratings on notes / FA providers / parent companies YE2001							
Abbreviated name of program & sponsoring firm	Prog. type (Euro/US/ Global)	FA-backed notes		FA provider insurance fin. strength		Parent senior debt	
		S&P	Moody's	S&P	Moody's	S&P	Moody's
AIG SunAmerica	E, G	AAA	Aaa	AAA	Aaa	AAA	Aaa
Allmerica	E	AA-		AA-	A1 (neg.)	A-	A2 (W-neg.)
Allstate	E, G	AA+	Aa2	AA+	Aa2	A+	A1
Combined (Aon)	E	AA (W-neg.)		AA (W-neg.)	A1 (neg.)	A+ (W-neg.)	A3 (neg.)
Jackson Nat'l (Pru plc)	E, G	AAA	Aa3	AAA	Aa3	AA	Aa3
John Hancock	E, G	AA+	Aa2	AA+	Aa2	A+	A1 (neg.)
MassMutual	E	AAA (neg.)	Aa1	AAA (neg.)	Aa1		
Monumental (AEGON)	E, G	AA+	Aa3	AA+	Aa3	AA-	Aa3 (neg.)
Nationwide	E, G	AA	Aa3	AA	Aa3	A	A2
New York Life	E	AA+	Aa1	AA+	Aa1		
Pacific Life	E	AA+	Aa3 (pos.)	AA+	Aa3 (pos.)		
Principal	E, G	AA (neg.)	Aa2	AA (neg.)	Aa2		
Protective	E, US	AA	A1	AA	A1	A	A3
Sun Life of Canada	E	AA+ (neg.)		AA+ (neg.)	Aa2 (pos.)		
Travelers (Citigroup)	E	AA	Aa1	AA	Aa1	AA-	Aa1

Sources: S&P and Moody's

Also evident in Exhibit 6 is the fact insurance financial strength ratings of operating companies are often two or three notches higher than senior debt ratings of holding companies, reflecting the seniority of policyholder claims over those of holding company creditors. For a holding company with a diverse mix of operating subsidiaries, the senior debt ratings can be closer to or equal to operating company financial strength ratings.

One more observation from Exhibit 6 is that Moody's is generally tougher than S&P on insurance financial strength ratings. For most insurers shown here, the Moody's financial strength rating is one or two notches lower than S&P's.

**Limits on issuance:** Both S&P and Moody's, when rating FA-backed notes, consider the volume of institutional spread business relative to other activities of the insurer. Exhibit 7 shows, for each program, the notes outstanding and authorized; assets and surplus of the FA provider; and assets and equity of the overall group. As a general rule, the rating agencies say that

liabilities associated with institutional spread business, including FA-backed notes, should not exceed about 30% of the FA provider's general account liabilities. According to the rating agencies, this ratio can not necessarily be determined from an insurer's financial statements because the relevant quantities may be grouped with other types of liabilities. Moreover, an apparent excess at a particular insurer could be mitigated by explicit or implicit support from the parent or other affiliates.

A simpler measure that we can readily see in Exhibit 7 is FA-backed notes relative to consolidated group assets. In most cases, the total amount of notes outstanding is less than one-tenth of consolidated group assets, confirming that FA-backed notes are not the main business but rather an incremental business of these firms.

**Exhibit 7**

Relative sizes of programs / FA providers / groups (USD billions)							
Abbreviated name of program & sponsoring firm	Prog. type (Euro/US/ Global)	Notes YE2001		FA provider YE2000		Parent/group YE2000	
		Issued	Authorized	Assets	Surplus	Assets	Equity
AIG SunAmerica	E, G	21.7	35.7	26.6	2.0	306.6	39.6
Allmerica	E	1.7	2.0	7.8	0.5	31.6	2.4
Allstate	E, G	3.7	7.0	38.8	2.6	104.8	17.5
Combined (Aon)	E	0.1	1.0	3.3	0.5	22.3	3.4
Jackson Nat'l (Pru plc)	E, G	5.1	10.0	41.0	2.2	231.3	13.2
John Hancock	E, G	9.4	11.3	61.8	3.7	87.4	5.8
MassMutual	E	1.6	2.0	65.8	3.8	73.7	5.3
Monumental (AEGON)	E, G	5.6	7.5	18.8	1.3	227.2	12.0
Nationwide	E, G	3.1	4.0	85.3	1.3	93.2	3.0
New York Life	E	0.7	3.0	69.3	7.0	97.1	8.7
Pacific Life	E	4.1	5.0	51.7	1.7	54.8	3.2
Principal	E, G	4.2	7.0	75.6	3.4	84.3	6.3
Protective	E, US	1.5	2.5	10.2	0.6	15.1	1.1
Sun Life of Canada	E	1.0	2.0	22.1	0.9	89.7	4.5
Travelers (Citigroup)	E	1.6	3.0	48.3	5.2	902.2	66.2

Sources: S&P and company reports

## US life & health sector — alive & well

The US life & health insurance sector has been consistently profitable during the past decade, lifting the aggregate statutory surplus from USD 77 billion at year-end 1990 to USD 183 billion at year-end 2000, for a compound annual growth rate of 9%. During the same period, the ratio of capital (surplus statutory plus asset valuation reserve) to total assets has improved from 6.4% to 7.0%. Exhibit 8 summarizes aggregate sector results for the past three years, based on statutory accounting practices ("SAP"). These aggregates, compiled by A.M. Best, reflect operations of 467 life & health groups and companies as of year-end 2000.

## Exhibit 8

### US life & health sector financial highlights (USD billions)

Balance sheet	31-Dec-98	31-Dec-99	31-Dec-00
Total invested assets	1,834	1,890	1,951
General account assets	1,902	1,965	2,031
Separate account assets	922	1,142	1,142
Total assets	2,824	3,106	3,173
Policy liabilities & deposit-type funds	1,515	1,563	1,614
Borrowed money	13	11	9
Asset valuation reserve (AVR)	38	40	38
Surplus notes	15	14	15
Policyholders' surplus (incl. surplus notes)	164	174	183
Policyholders' surplus & AVR	202	214	221

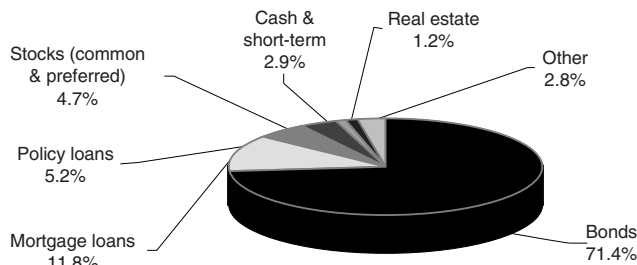
Income statement	12 months ended		
	31-Dec-98	31-Dec-99	31-Dec-00
Premiums & annuity considerations	269	272	302
Deposit-type funds	185	222	246
Net investment income	130	132	137
Total revenues	634	683	773
Pretax op. income (excl. capital gains)	23	27	30
Net income	18	21	24
Return on average assets (%)	0.7%	0.7%	0.8%
Return on average surplus (%)	11.4%	12.6%	13.5%

Source: A.M. Best

**Investments:** Investment quality is strong among US life & health insurers, as shown in Exhibits 9 and 10. The aggregate portfolio at year-end 2000 was 71% bonds, of which 93% were categorized as investment-grade by the National Association of Insurance Commissioners (“NAIC”). The NAIC rates bonds on a scale of 1-6, where the risk classes track closely with the Moody’s and S&P ratings indicated in Exhibit 10. The bonds include corporate, mortgage-backed, government and other obligations, with private placements accounting for about one-fourth of the total.

## Exhibit 9

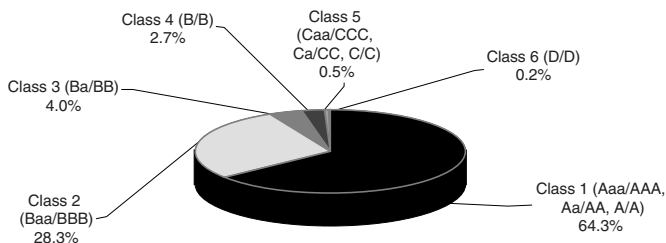
### US life & health sector investment mix at YE2000



Total invested assets: USD 1,951 billion (Source: A.M. Best)

## Exhibit 10

### US life & health sector bond quality at YE2000



Total bonds (incl. short-term invest.): USD 1,448 billion (Source: A.M. Best)

**Recent events:** On September 11, the global insurance industry suffered its most costly catastrophe loss ever — USD 24 billion and counting according to S&P. While most firms have ample resources to pay their claims, the incident has affected reinsurers and non-life insurers far more than life insurers. The estimated losses announced to date include USD 14 billion for reinsurers, USD 7 billion for non-life insurers and USD 3 billion for life & health insurers.

In our view, no firm with an FA-backed note program has suffered troublesome financial losses from this event. Two firms have posted sizable dollar losses — AIG (USD 820 million pretax) and Travelers/Citigroup (USD 502 million after tax) — primarily because of their commercial non-life insurance operations. Still, such losses represent less than 2% of shareholders’ equity for AIG and less than 1% for Citigroup.

As for the record-sized bankruptcy of Enron Corp., Moody’s has published a report estimating that US life insurers have aggregate investment exposure to Enron and affiliates in the vicinity of USD 3.9 billion, or about 2% of aggregate statutory surplus for the life & health sector. Companies are still working on specific loss estimates, but Moody’s says that it does not expect to take any life insurance rating action driven primarily by Enron exposure.

**Outlook:** Moody’s has a stable rating outlook on the US life & health sector dating back several years. S&P just raised its rating outlook from negative to stable in December 2001. The rating agencies cite the industry’s strong capitalization, operating performance and asset quality, along with good demand for protection products. These strengths are tempered by rising bond defaults and by the impact of fluctuating equity markets on variable products.

We believe that the sector benefits from strong growth in the US population aged 45 to 64 — prime years for earning and saving. The sector also benefits from the growing importance of private retirement savings plans in lieu of government schemes in the US and in other developed markets. We expect major life insurers to remain highly rated and to continue raising incremental funds through FA-backed notes.

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## **PRUDENTIAL INSURANCE COMPLETES DEMUTUALIZATION**

In December of last year, Prudential Financial, Inc. completed the largest initial public offering in the history of the insurance industry, selling 126.5 million shares of common stock at an offering price of \$27.50 per share. The total proceeds of the common stock offering were in excess of \$3.4 billion, including \$453.75 million raised when the underwriters exercised their overallotment option three days after the IPO closed.

Prudential Financial also sold \$600 million of equity security units at the same time as the IPO. The units were sold at a coupon of 6.75% and are mandatorily convertible into Prudential Financial shares at the conversion price of \$34.10 on November 15, 2004. The units have a conversion premium of 24% above Prudential Financial's \$27.50 per share IPO price.

Concurrently with the IPO, Prudential Financial sold in a private placement 2 million shares of Class B stock to institutional investors for an aggregate purchase price of \$175 million. The unusual terms of the Class B stock were designed to reflect the performance of a specific segment of the business known as the "Closed Block Business," which consists largely of traditional participating individual life insurance and annuity products. The purpose of the Class B private placement was to improve the value and investment attributes of the common stock, since there are relatively low returns in the participating products included in the Closed Block Business.

In December 2000, the board of directors of The Prudential Insurance Company of America adopted a Plan of Reorganization under which the company proposed to convert from a mutual structure to stock ownership. The Plan was filed with the New Jersey Commissioner of Banking and Insurance in March 2001 and was approved by the policyholders of Prudential Insurance Company in July 2001. The New Jersey Commissioner approved the Plan on October 15, 2001.

The demutualization extinguished policyholders' membership interests in The Prudential Insurance Company of America. Eligible policyholders will receive Prudential Financial's common stock, cash or policy credits (increases in policy values or other policy benefits). Prudential estimated that the amount of capital needed to compensate policyholders receiving

cash or policy credits and fund other expenses was about \$4.447 billion. Prudential Financial also issued an estimated 456.3 million shares of common stock to policyholders.

Prudential Financial, Inc. and its subsidiaries had approximately \$564.2 billion in total assets under management and administration as of September 30, 2001. The Prudential Insurance Company of America is the second largest life insurance company in the United States with total life insurance in force in the United States of \$1.3 trillion as of September 30, 2001.

Two other large insurance company demutualizations also occurred in the fourth quarter of 2001, giving much needed support to the IPO market which was struggling as a result of the economic downturn and the events of September 11th. Principal Financial Group, an insurance and financial services provider based in Des Moines, Iowa, sold about \$2.1 billion of common stock in its IPO. Anthem, Inc. a health insurer and Blue Cross licensee in eight states, completed an IPO with gross proceeds of nearly \$2 billion plus an offering of \$230 million of equity security units.

*For additional information concerning the Prudential demutualization, see [www.prudential.com](http://www.prudential.com). For additional information about the Principal Financial Group demutualization, see [www.principal.com](http://www.principal.com) and for additional information about the Anthem demutualization, see [www.anthem.com](http://www.anthem.com).*

## **EEOC SUES ALLSTATE INSURANCE COMPANY**

In late December, the United States Equal Employment Opportunity Commission filed a lawsuit against Allstate Insurance Company in the U.S. District Court for the Eastern District of Pennsylvania alleging that the company is violating the Age Discrimination in Employment Act ("ADEA"), Title VII of the Civil Rights Act of 1964 ("Title VII") and the Americans with Disabilities Act (the "ADA").

The lawsuit relates to decisions by Allstate to change its employee-agent sales force from their status as employees to independent contractors. For many years, Allstate's agents had been company employees, who received retirement and healthcare benefits and sold Allstate's insurance products on an exclusive basis.

In 1999, Allstate implemented a plan to convert all of its employee insurance agents to independent contractors. As of 1999 there were approximately 6,400 employee-agents employed by Allstate. The plan was

called “Preparing for the Future Program.” Under the plan, an employee-agent could elect to become an exclusive independent contractor agent for Allstate (Option 1), convert to an exclusive independent contractor agent status and sell the agent’s economic interest in his or her book of business to an approved buyer (option 2), or elect enhanced severance pay, including reimbursement for expenses after the close of the agent’s office (option 3).

Agents who elected one of the three options were required to sign a release and waive all of their claims under the ADEA, the ADA, and Title VII. Employee agents who did not sign a release and waiver by June 1, 2000 were not allowed to continue as insurance agents for Allstate but were entitled to receive Allstate’s normal severance benefits.

The EEOC contends that effectively what Allstate has done is to terminate its agent workforce and tell them they can come back to work if they sign a release agreeing not to sue. In September 2000, an EEOC District Director found that Allstate’s refusal to maintain individuals as insurance agents when they refused to execute the release and waiver “constitutes unlawful retaliation under Title VII, the ADEA and the ADA against those individuals who signed releases and also constitutes the unlawful interference, coercion and intimidation in the exercise and enjoyment of rights granted by the ADA.” After lengthy attempts to reach a settlement, the EEOC filed its lawsuit in federal court in Philadelphia.

The reason that the lawsuit was filed in Philadelphia is that twenty-nine insurance agents of Allstate had on August 1, 2001, filed a class action complaint in

the same federal court in Philadelphia against Allstate Insurance Company, The Allstate Corporation and Edward M. Liddy, president, chairman and chief executive officer of both companies, making allegations similar to the EEOC’s contentions. The EEOC intends to consolidate its action with the lawsuit of the private plaintiffs. In addition to the claims made by the EEOC, the agents allege that the terminations also violate their rights under the Employment Retirement Income Security Act (“ERISA”), the ADEA and the common law. Two of the staff attorneys of the AARP Foundation have joined the private lawsuit as co-counsel for the plaintiffs.

Allstate contends that it did not unlawfully terminate the agent’s employment contracts because they were at-will contracts. Allstate points out that the contracts of employee-agents were terminated, regardless of age, and all former agents were offered the same options on the same terms and conditions. Allstate also contends that each former employee-agent whose employment contract was terminated had the option to receive enhanced benefits in exchange for entering into a release that met all applicable legal requirements. Allstate also commented: “Releases are used routinely in the American workplace in connection with business reorganizations and have been consistently upheld in court. The company disagrees wholeheartedly with the EEOC’s position on the release and intends to vigorously defend the lawsuit.”

*For additional information concerning the litigation, see Allstate Corporation’s website at [www.allstate.com](http://www.allstate.com) and the website maintained by the legal counsel for the insurance agents at [www.allstatecase.com](http://www.allstatecase.com).*

To request related information or to be added to our "Insurance and Financial Services Report" mailing list, please fax or mail this form to Daniel P. Abercrombie, Bowne of Chicago, 325 West Ohio Street, Chicago, IL, 60610 Fax – (312) 527-6967, or to George R. Johnson, Bowne of New York, 345 Hudson Street, New York, NY 10014 Fax – (212) 229-3400.

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