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Lingering Losses on Bonds Are Haunting Insurers

By NORM ALSTER

In the wake of multibillion-dollar accounting scandals in American business, companies are under heightened pressure to make sure that their financial results do not paint a misleadingly rosy picture.

That pressure figures to be especially intense on the insurance industry.

Insurers are swimming in billions of dollars of losses on corporate bonds that they bought years ago, but whose value has since plummeted. With the leeway afforded by vague accounting rules, many insurers are still carrying these securities on their books as if nothing had happened. An effect is the deceptive appearance of financial strength.

Now federal regulators are suggesting that tighter rules may be required on how companies value distressed securities. A tightening could push life insurers, in particular, into a financial squeeze, requiring them to borrow billions of dollars or issue shares to maintain capital requirements.

Any company with sustained losses on its securities holdings must eventually take an earnings charge. But life insurers currently face the most acute risk because they pour more than 70 percent of their investment dollars into bonds. Even as the general bond market has been surging, credit-related declines in airline, telecommunications, utility and energy bonds have whacked insurers' investment portfolios.

"This three-year period had higher default rates on bonds than any period since the Great Depression," said Robert Riegel, managing director of the life insurance group at Moody's Investors Service. "And the life insurance industry has taken on the risk in their bond portfolios."

Investment problems may have already led some insurers to raise premiums. Several studies by Americans for Insurance Reform, a coalition of consumer groups, have concluded that poor investment performance — not greater claims and settlements — are the major reason for skyrocketing malpractice premiums. In Colorado, a study by the group found that payouts on medical malpractice claims actually declined even as malpractice premiums rose roughly 30 percent from 1998 to 2001.

Martin Weiss, chairman of Weiss Ratings, which rates the financial strength of insurers, also sees rising premiums as an effect of poor investments. "In the property and casualty business, premiums have been rising sharply," he said. "One of the big factors has been the decline in investment income, which includes portfolio losses."

Under current accounting guidelines, companies have wide latitude to determine when an investment loss is other than temporary. But once a company decides that an investment it holds is not likely to recover, it must deduct the loss from earnings.

Already, concern that many insurers are sitting on piles of distressed securities has prompted the Securities and Exchange Commission to ask some about how they determine if a depressed security is likely to recover. The S.E.C. has acknowledged issuing "a significant number of comments" to Fortune 500 companies on the issue.

UnumProvident, the nation's largest disability insurer, is one company that learned the unpleasant consequences of having to deal with a letter from the S.E.C. When Unum announced in February that the S.E.C. had asked for information on its accounting for impaired investments, its stock dropped nearly 15 percent the next day, to \$14.50 a share. It soon tumbled to less than \$6, as shareholders' lawyers scrambled to file class-action suits, and Moody's warned of a potential credit downgrade.

To fortify its finances, Unum decided to sell off many of its low-quality bonds and raise \$1 billion to bolster its own capital base. To resolve the issue with the S.E.C., Unum restated downward its earnings for 2000-02 by a relatively minor \$29 million. The stock has since recovered to trade around \$14 at the end of last week. But the company still had \$816 million in paper losses at the end of the first quarter, according to S.E.C. filings — some or all of which will lower future earnings.

"We do expect to see a continuation of credit-related loss in 2003," Thomas A. H. White, Unum's vice president for investor relations, said in an interview.

Some insurers have acted to head off regulatory questions. Joseph W. Smith Jr., chief investment officer at Aflac, said it was not directly questioned by the S.E.C. Still, Aflac decided this year to offer more detailed documentation of its investment holdings and valuation policies "to satisfy what we think the S.E.C. would want."

After reviewing financial filings by Fortune 500 companies last year, the S.E.C.'s corporate finance division cited accounting for impaired investment assets as one of its chief concerns. An S.E.C. spokesman declined to say how many insurance companies had been challenged. But a review of recent financial filings and pronouncements indicates that portfolio problems will gnaw at earnings in coming months.

In taking a first-quarter charge from investment losses, John Hancock Financial Services nearly doubled its estimate of charges for the year, to \$750 million from less than \$400 million. Despite taking more

than \$2.5 billion in investment charges last year, [MetLife](#) continues to hold many troubled airline securities and has more than \$1.2 billion in potential further losses. Aflac, which has avoided major charges so far, has \$286 million in unrealized losses from the below-investment-grade bonds of Ahold Financial, [KLM Royal Dutch Airlines](#) and others.

And the problem is not confined to these large companies. "Our opinion is that the life insurance companies in general have been slow in recognizing bond losses as 'other than temporary' and flowing them through their income statements," said Mr. Riegel at Moody's.

The danger for insurers, and ultimately for consumers, is a kind of avalanche effect. Poor investment performance hurts earnings and erodes the capital base upon which insurer ratings depend. If an insurer is downgraded by a credit agency, it may then need to conserve capital by cutting back planned purchases of its own stock or even to raise more capital, increasing its own borrowing costs. An insurer may then be tempted to raise premiums.

With life insurers especially exposed to credit-related bond problems, Moody's holds a negative outlook on that industry. "The whole issue of credit losses in investment portfolios is one of the major reasons we changed the outlook on the life insurance industry to negative," Mr. Riegel said.

For the holders of troubled bonds, the issue is timing. Though accounting rules require them to reduce the value of investments once losses are deemed to be other than temporary, the Financial Accounting Standards Board, whose guidance could clarify the issue, has never given precise direction on how to make that judgment.

As a result, companies use varying criteria to decide when a loss is unlikely to be reversed. "Some companies may look at bonds that are under water for a year or more," said Julie Burke, a managing director with Fitch Ratings. "Others may look at six months."

At [Hillenbrand Industries](#), which has taken write-downs for the holdings of its Forethought Life Insurance subsidiary, Mark Lanning, vice president and treasurer, said a security that remains down 20 percent for six months would warrant review. Even then, Hillenbrand's investment oversight committee could conclude the decline was reversible and avoid a charge. "We don't have a fine white line in the sand. This is definitely an area where accounting is an art, not a science," he said.

FASB has been unable to draw that fine white line, despite several meetings on the issue this year. "It's a very fundamental issue, and there's not a lot of definitive guidance out there," said Larry Smith, chairman of FASB's task force on emerging issues, which is studying the problem.

Where accounting guidelines are ambiguous, opportunities abound for masking bad news. Some companies try to offset investment write-downs with gains on appreciated bond holdings. "They may sell some securities to generate gains at the same time they're taking impairment charges," noted Dwayne D. Hallman, senior vice president for finance at [Horace Mann Educators](#), an insurer in Springfield, Ill.

Some ratings analysts argue that this practice is misleading. "If a company chooses to take interest-related gains to offset credit losses, this is window dressing," said Ms. Burke at Fitch Ratings. For one thing, interest rates can reverse course, obliterating gains. And to turn a paper gain into an earnings gain, the bondholder would have to sell the appreciated holding. But since bond prices are higher because rates are lower, the buyer would then have to reinvest the proceeds at a lower rate.