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August 24, 2001

The Honorable John D. Dingell
Ranking Minority Member
Committee on Energy and Commerce
House of Representatives

Subject: Summary of Reinsurance Activities and Rating Actions Tied to Selected Insurers Involved in the Failed "Unicover" Venture

Dear Mr. Dingell:

As you requested, this report provides information about activities associated with the highly publicized losses of an estimated $1 to $2 billion experienced by companies involved in reinsuring the occupational accident portion of workers' compensation (W/C) insurance policies.[1] These W/C "occupational accident" policies, commonly referred to as W/C "carve-out" policies, were brought to the reinsurance market by Unicover Managers, Inc. (Unicover), a reinsurance pool manager and intermediary. As explained further in enclosure I, reinsurance is the acceptance by one insurance company (the reinsurer) of a portion of the risk or claims loss underwritten by another insurance company for a share of the premium to support that risk. In a reinsurance pool arrangement, a number of reinsurers combine their capital and delegate underwriting authority to a pool manager that is normally not exposed to risk from the reinsurance. At the time this report was being prepared, legal and settlement activities were ongoing among insurance companies, firms engaged as reinsurance brokers, and the reinsurance pool managers involved with the failed Unicover reinsurance activities. As a result, for this report, we relied on information from sources other than the involved industry parties.

As agreed with your office, the objectives of this correspondence are to (1) summarize the business activities and events associated with losses of the failed Unicover venture and (2) describe the actions taken by five rating agencies on selected companies that were exposed to these losses. Additionally, we agreed to provide a brief update of regulatory efforts that were initiated as a result of the Unicover matter.

[1]Workers' compensation insurance generally has two components—coverage that includes "health" types of risks and employer liability coverage. The "health" portion covers losses associated with an injured employee's medical care, disability, accidental death benefits, etc. The other portion includes coverage for employer liability. An occupational accident reinsurance contract, or treaty, separates the employer liability portion of a W/C policy from the "health" types of benefits, providing reinsurance coverage for the "health" type risk.

Results in Brief

The losses associated with the failed Unicover venture came in the wake of rapid, high-volume, multilevel reinsurance of portions of W/C policies that were initially underpriced in the aggregate because of a highly competitive market. According to accounts of industry analysts and regulators, three Unicover-managed reinsurance operations, or facilities, generated reinsurance contracts with $2.5 billion in reinsurance premiums associated with W/C carve-outs. Upon reinsuring the policies, these Unicover-managed facilities transferred, or ceded, policy risk and the premium to other reinsurers, who often did the same. Multiple levels of reinsurance transactions were generated on these W/C carve-out policies during 1998. Along the way, many reinsurers counted on making money by keeping a portion of the premium as fee or commission income before ceding most or all of the policy risk to another reinsurer. Similarly, reinsurance brokers earned fee income on reinsurance transactions funded from the premium dollars. Industry analysts and regulators pointed out that reinsurers were eager for business and premium dollars at the time because of a "soft," competitive reinsurance market. At the same time, many insurance companies either did not have sufficient controls in place to ensure proper underwriting and limitations on the Unicover-related W/C carve-out reinsurance business received or anticipated being able to cede off all, or virtually all, of these exposures to other reinsurers while generating fee or commission income. As a result, these reinsurance activities had the effect of subsidizing unprofitable W/C insurance at the expense of insurance companies that reinsured the business. Belatedly, as the reinsurers began to discover the unusually high exposure and costs of reinsuring these W/C carve-outs relative to the premium they received, they began to take actions to "unwind," or cancel, the transactions.

Five rating agencies took a series of rating downgrade actions on two of the five insurance companies we reviewed that were involved in the Unicover-related reinsurance activities. The other three insurance companies experienced substantial losses but were not downgraded because either the insurer was more than adequately capitalized or the parent organization made capital contributions to cover the anticipated losses tied to the Unicover venture. The two insurers that were downgraded received a series of downgrades after the "Unicover debacle" was first publicly reported; about 1½ years later, most rating agencies identified these insurers as "vulnerable." However, the Unicover-related transactions were only partially responsible for the downgrade actions on these insurers because both were incurring losses on other key insurance business activities as well. Regulatory and rating agency officials explained that efforts to determine the nature and extent of reinsurance transactions associated with Unicover were hampered by delays in documenting and reporting the reinsurance transactions that had been consummated. The two downgraded companies we reviewed are presently under different degrees of regulatory control, and one has recently filed for bankruptcy protection. Other regulatory efforts are now underway to revise reporting requirements for insurance companies that engage in W/C carve out reinsurance business.

Background

Reinsurance is a mechanism that insurance companies routinely use to spread risk associated with insurance policies. Simply put, it is insurance for insurance companies. Reinsurance is a normal business practice that satisfies a number of needs in the insurance marketplace, including the need to expand capacity, stabilize loss experience, obtain protection against potential catastrophes, reduce reserve requirements, and other services.

The insurance industry is primarily divided along two lines, property-casualty (P/C) insurance and life-health insurance. In turn, insurance companies are licensed by the state insurance departments to conduct business within the P/C side of the industry or within the life-health side of the industry, but generally not both.

W/C insurance is the largest P/C commercial line of insurance in the industry. According to an industry report, W/C insurance accounted for over $22 billion of premium volume, representing nearly 8 percent of the commercial insurance industry's entire premium volume and over 16 percent of the total commercial premium volume in 1999.[2] W/C insurance is underwritten by P/C insurers. However, life insurance companies have engaged in reinsurance activities on certain "health" types of risks that are included in W/C policies. Enclosure I provides a more detailed summary of reinsurance concepts.

As illustrated in figure 1, W/C insurance has two principal components:

- "health" coverage, including that for an injured employee's medical care, disability payments, and accidental death benefits, and
- employer liability coverage.

An occupational accident reinsurance contract, or treaty, separates the employer liability portion of a W/C policy from the "health" types of benefits, providing reinsurance coverage for the "health" type risk. Specifically, the W/C carve-out business is reinsurance assumed by life and health insurers of medical, wage loss, and death benefits of the occupational illness and accident exposures—but not the employers' liability exposures—of business originally written as W/C insurance."[3]

According to state insurance regulators and industry analysts, the W/C carve-out business has been more common in the London reinsurance market than in the United States. In the past, the W/C carve-out business in the United States has typically been associated with catastrophic protection on a group of employees where reinsurance coverage would not be triggered until relatively high losses were experienced (e.g., millions of dollars).

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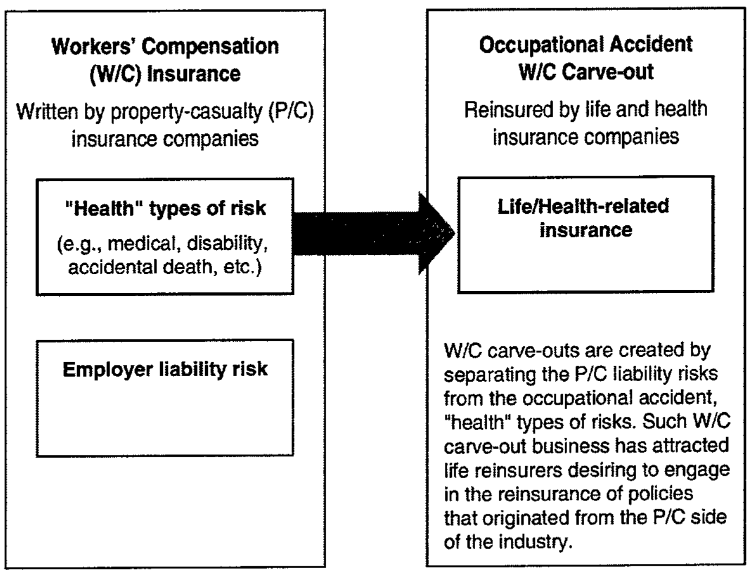
[2] Net premium figures written by lines of property-casualty insurance (figures from A.M. Best Company, Inc.), *The Fact Book 2001*, Insurance Information Institute.
[3] *Report of the Underwriting and Reinsurance Pools Working Group*, presented at the NAIC 2001 Summer National Meeting (June 2001).

Figure 1: A Simplified Illustration of Workers' Compensation "Occupational Accident Carve-outs"



Source: GAO summary of insurance analyst and regulatory information.

Rating agencies provide current or prospective investors, creditors, and policyholders with independent analyses of insurance companies' overall financial strength, creditworthiness, ability to pay claims, and other aspects of companies and their activities. The rating that a company receives from a rating agency can help determine the type of insurance products it can offer in the marketplace. For example, commercial customers are generally unwilling to buy insurance from a low-rated insurer, because that insurance company may not be there to pay the claims in the future. While all rating agencies conduct analyses of companies' financial information that is in the public domain, rating agencies are often in frequent contact with the management of the companies they rate to assess other nonpublic or proprietary information. Rating agencies are also independent of regulatory bodies.

Scope and Methodology

To accomplish our first objective, we interviewed and/or collected data from state insurance regulators in Connecticut, Pennsylvania, New York, Illinois, and California as well as information from the National Association of Insurance Commissioners (NAIC).[4] We also interviewed and/or collected information from insurance industry analysts, investment firms, and trade associations, including the American Council of Life Insurers (ACLI); Dowling & Partners Securities, LLC; PaineWebber, Inc.; Morgan Stanley Dean Witter; and the Reinsurance Association of America (RAA).

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[4]NAIC is a voluntary association of the heads of each state insurance department, the District of Columbia, and four U.S. territories. NAIC assists state insurance by providing guidance, model (or recommended) laws and regulations, and information-sharing tools.

In addition, we reviewed analyses of the corporate governance, internal controls, and risk management of some of the insurers involved in Unicover, as provided by industry analysts, regulators, and Unicover participants. We also conducted literature searches and interviewed insurance regulatory officials to identify problematic issues and key players involved in the reinsurance activities associated with Unicover as well as ongoing regulatory efforts in the aftermath of the failed venture. We did not interview officials of the five selected insurance companies, given the sensitive nature of ongoing legal activities and settlement negotiations among a number of parties tied to the failed Unicover venture.

To accomplish our second objective, we sought ratings data on selected insurers out of the numerous P/C and life insurance companies that participated in Unicover-related W/C reinsurance activities. We collected ratings history data on the following five insurance companies that played a variety of roles in the failed Unicover-related reinsurance activities:

- Cologne Life Reinsurance Company (Cologne Life Re),
- Fremont Compensation Insurance Company (Fremont),
- Phoenix Home Life Mutual Insurance Company (Phoenix Home Life),
- Reliance Insurance Company (Reliance), and
- Sun Life Assurance Company of Canada (Sun Life of Canada).

Specifically, we collected ratings data for the period of February 1999 to January 2001 on one insurer that participated as a primary W/C insurer (Fremont), one that participated in the Unicover facilities as a "fronting" insurance company[5] (Reliance), one that was both a member of the Unicover pool facility and a direct retrocessionaire[6] to the Unicover facilities (Cologne Life Re), and two other direct retrocessionaires to the Unicover facilities (Phoenix Home Life and Sun Life of Canada). To understand the rationale for ratings determinations made on these firms tied to the Unicover venture (concerning the insurers' overall financial strength ratings), we discussed these matters with or received comments from the following five rating agencies: A.M. Best, Fitch, Moody's, Standard & Poor's, and Weiss. We did not request information considered by the rating agencies to be proprietary in nature.

[5]A fronting insurance company is one that, for a fee, issues (or reinsures) policies on behalf of another insurance company and subsequently transfers all, or substantially all, of the risk to the other company by means of reinsurance. Such an arrangement can be used if a reinsurer is not licensed to conduct business in a particular market or in conjunction with a reinsurance facility (described further in enc. I).
[6]Transactions involving the reinsurance of reinsurance contracts are called retrocessions. A retrocessionaire is a reinsurer that contractually accepts from another reinsurer a portion of the ceding company's underlying reinsurance risk. These transactions involve the transfer of premium and risk from a reinsurer to a retrocessionaire. Retrocessionaires may, in turn, seek retrocessional protection, which further increases the levels of retrocessional coverage.

Reinsurers Experienced Losses Following Rapid, High-volume, MultiLevel Reinsurance Activities on Unprofitable Workers' Compensation Policies

In 1998, three Unicover-managed operations reinsured an estimated $2.5 billion (in reinsurance premiums) of occupational accident W/C carve-outs, an amount industry analysts and regulators have described as "huge" and "enormous." One industry study estimated that about 15 percent of the total U.S. W/C business was ceded into the Unicover-managed facilities.[7] Upon reinsuring the W/C carve-outs, the reinsurers associated with the Unicover facilities, in turn, reinsured their W/C reinsurance treaties with other reinsurers, known as retrocessionaires, who also sought reinsurance coverage. Ultimately, multiple levels of reinsurance transactions were consummated on the W/C carve-out business. However, the underlying W/C policies were originally written in a soft, or highly competitive, market and were priced at a loss in the aggregate.[8] That is, the original premiums collected by the primary, or originating, W/C insurers were less than the amount that would ultimately be needed to pay the resulting claims. Reinsurance coverage on these W/C carve-outs was triggered at unusually low dollar thresholds where the frequency of claims and servicing costs would be higher as compared with that associated with more catastrophic protection. As pointed out by industry analysts after the Unicover-related transactions were revealed, the underlying W/C policies had been priced at unprofitable levels. This problem was exacerbated at each level of reinsurance because, in the aggregate, reinsurers accepted the risk exposures for a smaller and smaller share of the premium. As reinsurers at various levels in the transactions realized the magnitude of their potential exposures, they began taking actions to prevent further expansion of these reinsurance activities and, to the extent possible, unwind the transactions.

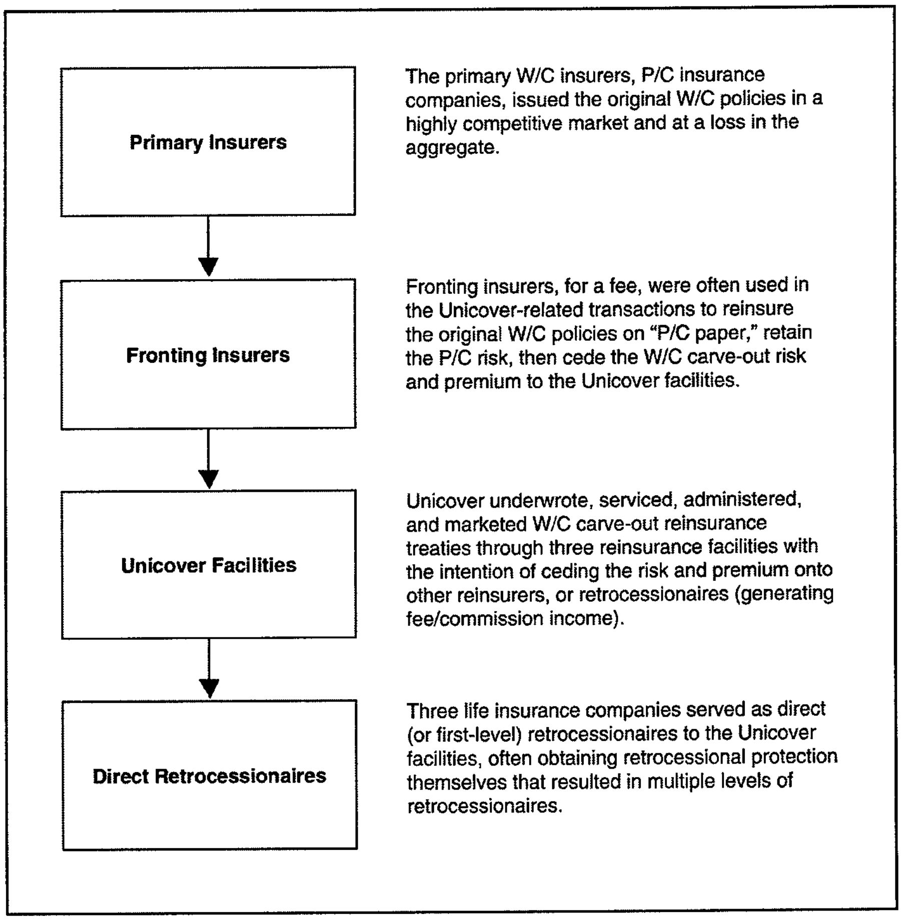
The flow of insurance risk and premium associated with the Unicover venture began with the underlying policies written by the primary P/C insurers. Unicover Managers, Inc., formed in 1994 and licensed as a reinsurance intermediary by Illinois in 1997, sought to reinsure this W/C business on behalf of other insurance companies associated with Unicover's reinsurance operations. To carry out its reinsurance activities, Unicover formed three facilities and served as the reinsurance underwriting manager for them. One facility was a reinsurance pool of five highly rated life insurance companies that Unicover managed on behalf of the pool members. Two other facilities, referred to as Reliance and Lincoln National, were also established with a single insurance company for each (see enc. I).

Unicover's primary business was organizing and managing reinsurance facilities to assume occupational accident carve-outs of W/C insurance policies written by U.S. insurers. These reinsurance activities took place either directly between the primary P/C insurer and the reinsurance pool, or through a fronting insurer that would reinsure the initial W/C policy with the intention of ceding the risk and premium directly to other reinsurers, or retrocessionaires. According to industry analysts, Unicover created a retrocession program with three life insurance companies so that W/C carve-outs

[7] *Untangling Unicover: An Investor Handbook;* PaineWebber, Inc.; December 1999.
[8] Pricing insurance with an underwriting loss in and of itself is not an uncommon practice for insurance companies because, along with the anticipated claims loss, insurers also consider the investment earnings on the premium received.

reinsured by the Unicover facilities would, in turn, be reinsured by the retrocessionaires. Unicover and its associated reinsurers would generate fees and commission income. Figure 2 identifies the common flow of risk and premium in the Unicover-related reinsurance transactions.

Figure 2: Parties Involved in the Unicover Arrangement



Source: GAO summary of insurance industry analyst and regulatory information.

With the retrocessional reinsurance protection in place behind them, the Unicover-managed facilities generated a significant volume of W/C carve-out business, passing premium and risk to three direct retrocessionaires. In turn, the retrocessionaires also had retrocessional coverage. Eventually, multiple levels of retrocessional treaties developed that encompassed the Unicover-related W/C carve-out business.

As the various reinsurance treaties were consummated through the Unicover facilities and on to multiple levels of retrocessionaires, various fees and commissions were paid that decreased the premium available at each level to support the risk being passed on.[9] For instance,

- an insurance company ceding the risk to the next reinsurer would collect a ceding commission on the block of business reinsured,
- fronting insurers would collect a "fronting fee" (from the premium that was ceded to other insurance companies), and
- Unicover would collect management fees tied to a percentage of the premium volume underwritten through the Unicover facilities and a percentage of any profit generated by the facilities.

In late 1998, the retrocessionaires, ultimately holding a disproportionate share of the risks in relation to the premium ceded to them, began to question the nature and potential exposure of the Unicover-related reinsurance transactions. As a result, they began to take steps to terminate future business generated through the Unicover facilities and to dispute or repudiate existing contracts—that is, they began to refuse to pay claims on retrocessional treaties. Figure 3 provides an overview of activities and events associated with Unicover.

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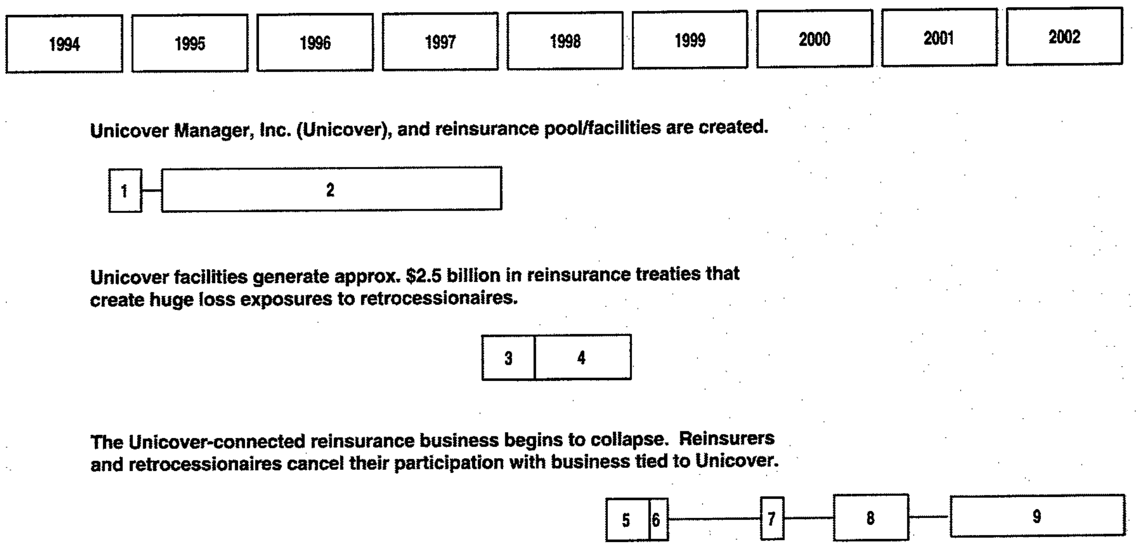
[9]The risk passed on to the retrocessionaires associated with the Unicover-related W/C carve-out business was not shared equally. Some retrocessionaires had extensive retrocessional coverage themselves so their exposures from the Unicover-related reinsurance treaties were reduced as these exposures were shared with other retrocessionaires. Other retrocessionaires that had limited retrocessional protection were more exposed to the risks they inherited from the W/C carve-out reinsurance treaties.

Figure 3: An Overview of Activities and Events Associated With Unicover



1. December 1994, Unicover Managers, Inc., is formed and later operates as an underwriting manager on behalf of other insurance companies.
2. March 1995 - December 1997, Unicover forms the Unicover Pool (with five participant life insurance companies) and retrocessional coverage.
3. December 1997 - March 1998, Unicover establishes new reinsurance facilities, Reliance and Lincoln National along with the Unicover Pool, and establishes new retrocessional agreements with three life insurance companies.
4. March 1998 - January 1999, Unicover begins its 4th underwriting year and consummates approximately $2.5 billion in reinsurance treaties that ultimately lead to losses to and disputes with retrocessionaires.
5. November 1998 - March 1999, Life companies terminate participation in Unicover Pool and retrocessional program.
6. February 1999, Cologne Life Re announces $275 million pretax loss and the Connecticut Dept. of Insurance rejects practice of reinsuring W/C carve-outs.
7. January 2000, Major settlements and other insurer charges begin to materialize.
8. August 2000 - February 2001, Some insurer losses trigger increased regulatory control and supervision.
9. August 2001 - 2002, Unicover-related legal/settlement actions are expected to continue.

Source: GAO summary of insurance analyst and regulatory information.

Industry analysts generally agree that the rapidly executed, high-volume, multilevel reinsurance that Unicover initiated had the effect of subsidizing unprofitable W/C insurance, which primary insurers sold at the expense of insurance companies that reinsured the business. In the reinsurance transactions, each subsequent participant paid commissions and management fees. Because the underlying W/C policies were underpriced initially and because ceding and broker commissions along with underwriting manager fees were being deducted with the transfer of premium, the potential losses became increasingly greater at each level than the premium left to cover them. Industry analysts and regulators explained that the companies did not have sufficient controls to ensure proper underwriting of the W/C carve-out reinsurance contracts or were indifferent to the exposures as they anticipated ceding all, or virtually all, of the policy risk to another insurance company. Belatedly, companies facing Unicover-related losses took action to unwind the transactions. The transactions began to unravel in early 1999.

According to regulators and industry analysts, the factors that contributed to the failure of the Unicover venture included

- a lack of experience in pricing reinsurance coverage that was triggered at unusually low thresholds, thereby increasing exposure to losses (e.g., coverage for losses on W/C policies exceeding $50,000 instead of a threshold set in the millions);
- a huge volume of W/C carve-out reinsurance business was quickly placed in the Unicover facilities and passed onto the retrocessionaires, an amount that far exceeded their expectations;
- underlying W/C policies that were initially underpriced in the aggregate, exacerbated by an estimated $500 million in various fees and commissions associated with multiple layers of reinsurance transactions;
- weaknesses in corporate governance, internal controls, and risk management that did not ensure proper underwriting and limitations as managing general agents/underwriters were "given the pen" to write W/C carve-out business generated through the Unicover facilities; and
- the expectation of being able to collect fee or commission income while passing all, or virtually all, of the risk to another insurance company by means of reinsurance.

As previously mentioned, losses to risk-bearing companies participating in the debacle are estimated to be $1 to $2 billion. One industry analyst letter cited over $1.1 billion (pretax) in Unicover-related charges taken by many of the primary participants, with other participant charges and legal costs expected in the future.[10]

Rating Agencies Took Downgrade Actions on Selected Insurance Companies Exposed to Unicover-related Reinsurance Losses

The actions taken by five rating agencies on five insurance companies exposed to losses from Unicover-connected business transactions were influenced by a variety of factors that impacted the insurers' ratings differently. Some insurers' financial strength ratings were not reduced, while others were downgraded in part because of the Unicover debacle. Overall, the rating firms generally cited the same rationale for their rating decisions. The data we reviewed on this subject covered the period of February 1999 through January 2001.

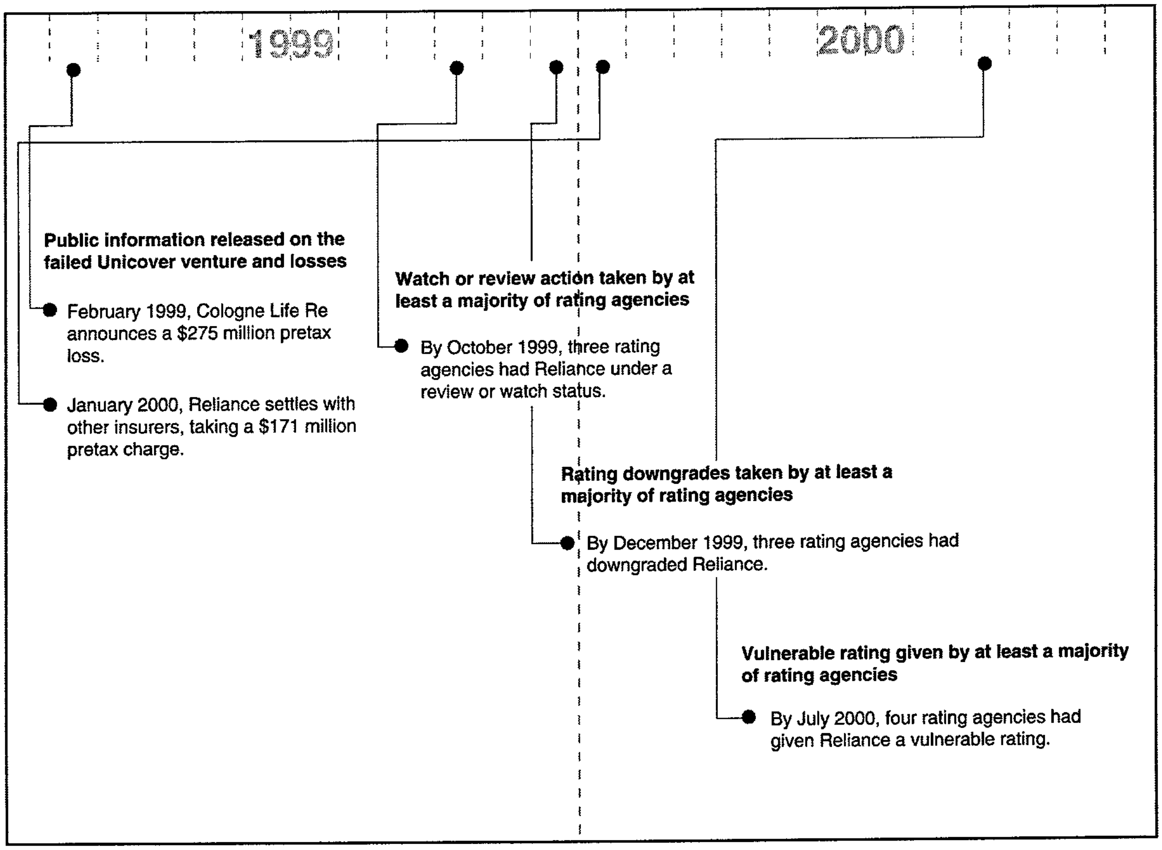
We found that the rating companies generally became aware of the Unicover-related problems by February 1999, the month in which Cologne Life Re announced it would be taking a $275 million pretax charge on its year-end 1998 financial statements. The announcement of this charge was a noteworthy "wake-up call" because its magnitude was sufficiently large to cause Cologne Life Re's insolvency had it not been supported by the parent organization.

[10]*Unicover Revisited: A Mountain Turned Into a $1 Billion Molehill*, Moody's Investors Service, Special Comment Letter, March 2001.

Most of the rating downgrades we found in our study were focused on Reliance and Fremont. After placing the insurance companies on watches or reviews, all five rating agencies took a series of downgrades on Reliance and Fremont. The timing of the rating actions varied by rating agencies, although most identified the insurance companies as "vulnerable" at about the same time. As reasons for the downgrades, the rating firms generally cited problems in the insurers' core business activities in addition to losses anticipated from the Unicover-related business. The rating agencies emphasized that Unicover was a contributing factor to the downgrades, but not the principal factor. (Enc. II contains more detailed information on the rating actions taken by the five rating agencies and our summary of their rationale for these actions.) Ultimately, Reliance and Fremont were placed under regulatory control. Reliance was placed into Rehabilitation by an Order of the Commonwealth Court of Pennsylvania on May 29, 2001, which named the Pennsylvania Insurance Commissioner as Statutory Rehabilitator. Reliance Group Holdings, Inc., the parent company of Reliance, subsequently filed for Chapter 11 federal bankruptcy protection in June 2001.

Specifically, the rating actions taken on Reliance began with watch or review actions in 1999 followed by a series of downgrade actions in late 1999 and 2000. The majority of the rating firms (three of five) had placed Reliance on watch or review by October 1999. By December 1999, a majority of the rating firms had taken their first downgrade action against Reliance. Eventually, by July 2000, most of the rating firms had downgraded Reliance to the point of characterizing it as vulnerable. Figure 4 summarizes the actions taken on Reliance by the majority of the rating agencies between February 1999 and January 2001.

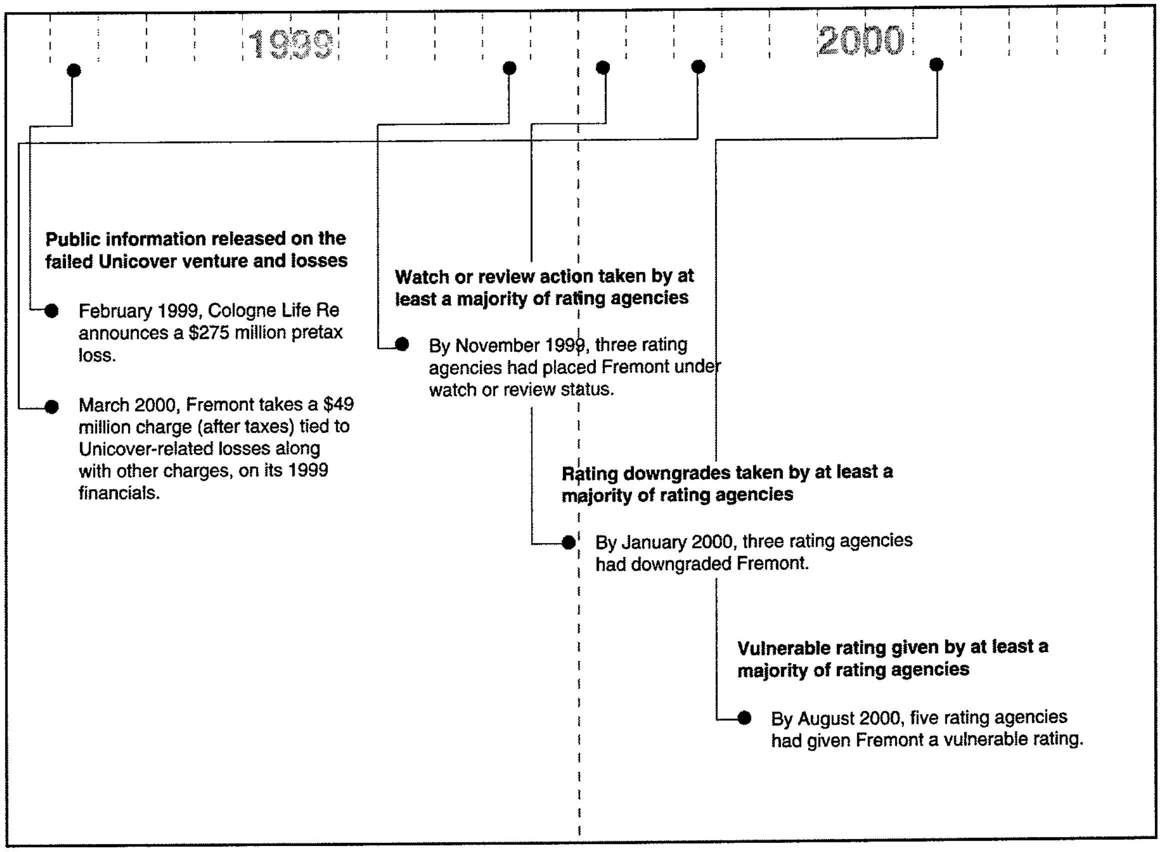
Figure 4: Summary of Rating Actions Taken on Reliance by a Majority of Rating Agencies (at Least Three of Five), 1999 Through 2000



Source: GAO summary of ratings data on Reliance from A.M. Best, Fitch, Moody's, Standard & Poor's, and Weiss.

The rating actions taken on Fremont followed a similar pattern. In November 1999, the majority of rating firms had placed Fremont on watch or review status. By January 2000, a majority of the rating firms had downgraded Fremont. Later, in August 2000, all five of the rating agencies considered Fremont a vulnerable insurance company. Figure 5 illustrates the rating actions taken on Fremont between February 1999 and January 2001.

Figure 5: Summary of Rating Actions Taken on Fremont by a Majority of Rating Agencies (at Least Three of Five), 1999 Through 2000



Source: GAO summary of ratings data on Fremont from A.M. Best, Fitch, Moody's, Standard & Poor's, and Weiss.

For the three remaining insurers we reviewed, Cologne Life Re, Phoenix Home Life, and Sun Life of Canada, virtually no watches, reviews, or rating downgrades resulted. Again, these rating agencies cited similar rationales, explaining that the three insurers generally did not receive rating downgrades because either the insurer was more than adequately capitalized or the parent organization made capital contributions to cover the anticipated losses tied to the Unicover venture.

Some Regulatory Efforts Are Underway to Address the Unicover Debacle

Insurance regulators have acknowledged the difficulties in detecting and monitoring reinsurance activities involving W/C carve-out types of policies. As pointed out by regulators and industry analysts, the W/C carve-out business is less common in the United States than in Europe, and has traditionally been associated with catastrophic protection (e.g., coverage on multiple lives in a single event triggered at relatively high dollar thresholds). According to a recent NAIC report, while some states explicitly prohibit an insurer from one segment of the industry (e.g., a life insurance company) from reinsuring products that originated from another industry segment (e.g., a P/C insurance business), most states' laws do not specifically address the issue of W/C carve-outs.[11] Regulatory and rating agency officials also pointed out that there can be delays in documenting and reporting reinsurance transactions that have been consummated. Furthermore, many insurance regulators hold the view that it is not within their oversight responsibility to police individual reinsurance business transactions between insurance companies, as such transactions involve sophisticated parties that should know what they are doing.

Concerning specific regulatory actions taken in the aftermath of the failed Unicover venture, we found that insurance regulators in some states were working with the insurers to resolve issues on the Unicover matter. When the Unicover matter first came to light, regulators in Connecticut issued a bulletin to their domestic life insurance companies in February 1999 to clarify that insurers not authorized to directly write W/C insurance should not engage in reinsurance activities on W/C business that has been transformed into occupational accident insurance, on the basis of existing state law. In Pennsylvania, the Department of Insurance commenced a financial examination of Reliance in March 2000 and took a more proactive, supervisory role in August 2000 through a letter of agreement with the insurer.[12] In May 2001, Pennsylvania's Commonwealth Court issued an Order of Rehabilitation on Reliance. Subsequently, Reliance's parent organization filed for Chapter 11 federal bankruptcy protection in June 2001. Meanwhile, Fremont continues to operate under increased regulatory control through an agreement reached with the California Department of Insurance in November 2000.

Some regulatory efforts are now underway to study W/C carve-out reinsurance business and modify reporting procedures to better inform regulators of such business activity. In the aftermath of the failed Unicover venture, NAIC established a working group in September 1999 to study issues concerning the W/C carve-out business further. State insurance regulators are now working through NAIC to modify reporting requirements to more explicitly highlight reinsurance activities involving W/C carve-out business on insurer financial statements. In June 2001, NAIC's Underwriting and Reinsurance Pools Working Group issued a report that recommended allowing life-health insurers to engage

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[11] *Report of the Underwriting and Reinsurance Pools Working Group*, presented at the NAIC 2001 Summer National Meeting (June 2001).

[12] On August 18, 2000, Reliance and the Pennsylvania Insurance Department entered into an agreement that required prior approval of the Insurance Department for any dividends or other distributions paid by Reliance.

in the W/C carve out business provided that they meet new reporting requirements to disclose such transactions more explicitly to regulators.

Other legal and settlement activities are ongoing between various insurance companies, reinsurance brokers, and Unicover. Concerning any further regulatory examination of Unicover, state insurance regulators in Illinois mentioned that the organization did not seek to renew its license as a reinsurance intermediary. As of June 2001, the Illinois Department of Insurance did not intend to examine records associated with Unicover because, according to state regulatory officials, no regulatory body had requested such an effort and Unicover Managers, Inc., was not a risk-bearing entity.

As agreed with your office, unless you publicly release its contents earlier, we plan no further distribution of this letter until 30 days from its date. At that time, we will send copies of this letter to the Chairman of the House Committee on Energy and Commerce as well as the Chairmen and Ranking Minority Members of the House Committee on Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs. We will also send copies to the President of NAIC and make copies available to other interested parties.

Please contact me or Lawrence D. Cluff at (202) 512-8678 if you or your staff have any questions about this letter. Major contributors to this letter were Jim Black; Deatra Brandon; Thomas Givens, III; Rosemary Healy; Shirley Jones; Barry Kirby; Beth McCosh; Angela Pun; LaSonya Roberts; and Desiree Whipple.

Sincerely yours,

Davi M. D'Agostino

Davi M. D'Agostino
Director, Financial Markets and
Community Investment

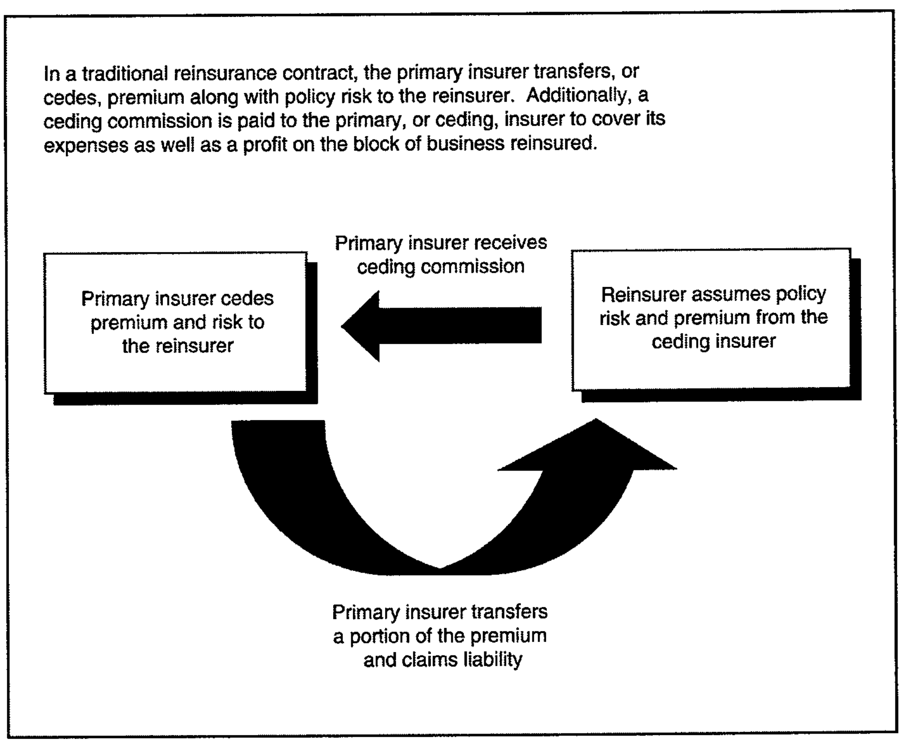
Enclosure I

Summary of Reinsurance Activities Tied to the Unicover Venture

Reinsurance is a mechanism that insurance companies use to spread risk associated with insurance policies so that a single insurer is not burdened beyond its ability to meet its policy obligations. The insurer purchasing reinsurance is known as the ceding insurer; the company selling reinsurance is known as the assuming insurer, or more simply, the reinsurer. For a premium, the reinsurer protects the ceding insurer against losses associated with its policies. It is important to note that the primary insurer remains directly obligated to pay for claims on the underlying policies, even though it may have obtained reinsurance to cover losses on those policies. Figure 6 depicts the basic characteristics of a reinsurance transaction.

As reinsurance contracts, or treaties, are consummated, various fees and commissions may result. Commonly, the reinsurer pays a ceding commission to the ceding insurer to cover expenses and provide a profit associated with the block of business reinsured. Also common is a fee paid to third-party reinsurance intermediaries, or brokers, who help match ceding insurers with reinsurers.

Figure 6: Basic Reinsurance Transaction



Source: GAO summary of insurance industry information.

Reinsurance contracts can also be consummated by two reinsurers. These transactions, called retrocessions, involve the transfer of premium and risk from a reinsurer to a retrocessionaire. A retrocessionaire is a reinsurer that contractually accepts from another reinsurer a portion of the ceding company's underlying reinsurance risk. Retrocessionaires may in turn seek retrocessional protection, which further increases the levels of retrocessional coverage. As with reinsurance contracts, retrocessional arrangements are also accompanied by ceding commissions and broker fees.

Reinsurance contracts are typically carried out with the primary insurer retaining a portion of the policy risk while ceding another portion of the policy's risk and premium to the reinsurer. Reinsurance can be "sliced" by layers so that coverage can apply to a specific range of dollar losses tied to a policy. For instance, insurers (or reinsurers) can obtain reinsurance (or retrocessional) protection for losses that fall within a dollar amount range. In such cases, the premium dollars must be allocated appropriately to support the risk associated with each loss layer.

Insurance companies sometimes engage in reinsurance activities by participating in a reinsurance pool. In a reinsurance pool, reinsurers combine their capital and receive a certain share of premium and risk generated through the pool. Pool members appoint a manager to run the day-to-day activities of the pool. Pool managers generally do not assume underwriting risk themselves, but rather, on behalf of the pool members.

Another type of reinsurance arrangement is known as a reinsurance facility. The purpose of such a facility is to generate reinsurance contracts that, in turn, can be marketed to other insurance companies. A facility can be operated through a single insurance company or a pool of insurance companies. An underwriting manager conducts the day-to-day affairs of the facility.

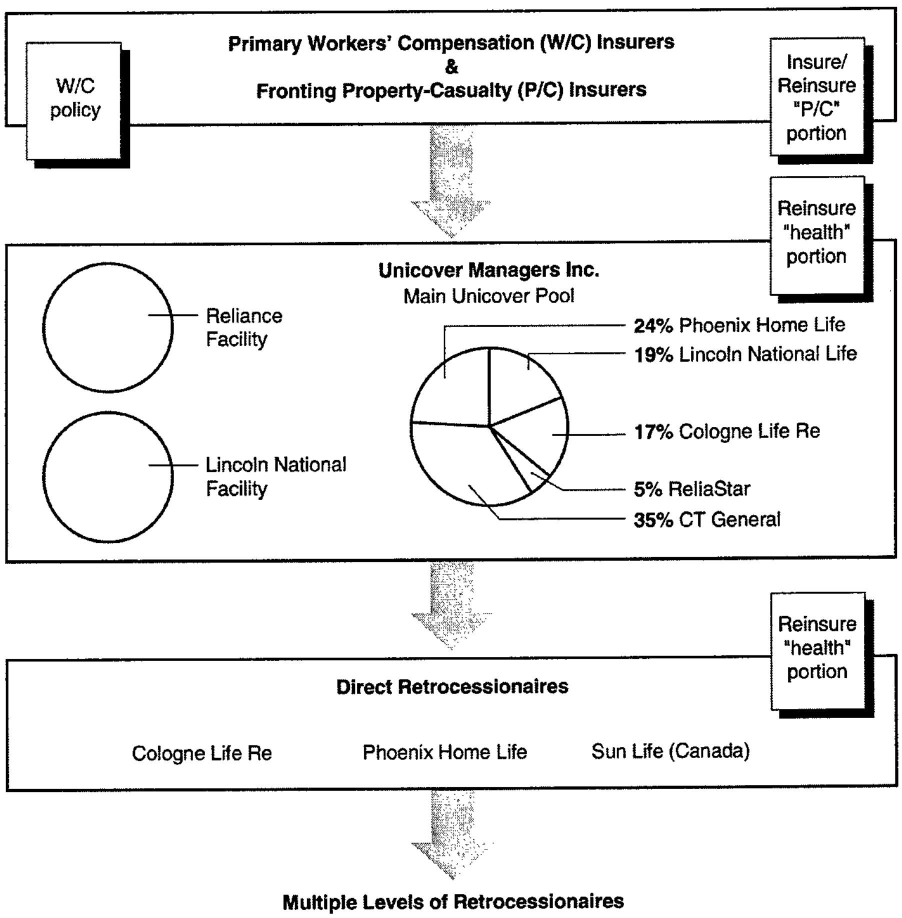
A practice also used in the reinsurance industry is known as "fronting." A fronting arrangement involves the use of an insurer (or reinsurer) that, for a fee, issues (or reinsures) policies on behalf of another insurance company and subsequently transfers all, or substantially all, of the risk to the other company by means of reinsurance. Such an arrangement might be used when a reinsurer is not licensed to conduct business in a particular geographic area or in conjunction with a reinsurance facility.

Summary of Unicover-connected Reinsurance Activities

Unicover Managers, Inc. (Unicover), operated as an underwriting manager for three reinsurance facilities it developed—the Unicover Pool Facility, Lincoln National Facility, and Reliance Facility. Through these facilities, numerous reinsurance treaties were underwritten on the occupational accident portion of workers' compensation (W/C) policies, also known as W/C carve-outs. Five insurance companies were associated with the Unicover Pool, while each of the other facilities was formed from a single insurance company.

The Unicover facilities often made use of fronting arrangements—that is, the policies of the primary insurers were first reinsured by a fronting reinsurer. Through the Unicover facilities, certain layers of policy risk and a portion of the premium associated with these W/C carve-out policies were then ceded to three other reinsurers, or retrocessionaires. These retrocessionaires, in turn, had varying degrees of retrocessional coverage. Figure 7 provides a simplified structure and flow of the Unicover-related reinsurance activities.

Figure 7: Simplified Flow of the Unicover-related Reinsurance Transactions



Source: GAO summary of insurance analyst and regulatory information.

Ultimately, the retrocessionaires (at multiple levels) discovered that the premium received was insufficient to cover the risk associated with the loss layers they had reinsured. One by one, the retrocessionaires began to take actions to halt W/C carve-out reinsurance business generated by the Unicover facilities. As the retrocessionaires began to dispute the matter, insurance companies "further up the chain" (e.g., primary and fronting reinsurers) were obligated to pay claims on their policies as they waited to recover money on their reinsurance coverage from the retrocessionaires.

Ratings Data on Selected Insurers Tied to the Unicover Venture

Tables 1 and 2 summarize the actions of five principal rating agencies in rating the financial strength of Reliance Insurance Company (Reliance) and Fremont Compensation Insurance Company (Fremont). The tables list the timing, by month and year, of the rating watch or review actions; rating downgrade actions; and vulnerable ratings, as defined by the rating firms.

Table 1: Summary of Rating Actions Taken on Reliance, February 1999 to January 2001

Rating firm	Watch or review actions	Downgrade actions
A.M. Best	Oct. 1999 Feb. 2000 June 2000 July 2000 Aug. 2000	June 2000 July 2000 (vulnerable) Aug. 2000 Dec. 2000 Jan. 2001
Fitch	June 1999 Nov. 1999 Mar. 2000 June 2000 * July 2000 * Aug. 2000	Nov. 1999 June 2000 July 2000 (vulnerable) * Aug. 2000
Moody's	Nov. 1999 May 2000 June 2000 July 2000	June 2000 (vulnerable) July 2000 Nov. 2000
Standard & Poor's	June 1999 Oct. 1999 Mar. 2000 June 2000 July 2000 * Aug. 2000 *	Aug. 1999 June 2000 July 2000 (vulnerable) Aug. 2000 *
Weiss	+	Dec. 1999 Sep. 2000 (vulnerable) Dec. 2000

Legend

vulnerable = Signifies the time when the rating agency first identified the insurer as a vulnerable insurance company during the period, according to its ratings definitions.
* = Denotes more than one rating action taken during the month.
+ = Indicates no separate watch or review action taken.

Table 2: Summary of Rating Actions Taken on Fremont, February 1999 to January 2001

Rating firm	Watch or review actions	Downgrade actions
A.M. Best	Aug. 1999 Aug. 2000	Mar. 2000 Aug. 2000 (vulnerable) Dec. 2000
Fitch	+	Mar. 2000 May 2000 Aug. 2000 (vulnerable) Dec. 2000
Moody's	Nov. 1999 Aug. 2000	Jan. 2000 Aug. 2000 (vulnerable) Nov. 2000
Standard & Poor's	Nov. 1999 May 2000 Aug. 2000 *	Jan. 2000 May 2000 Aug. 2000 (vulnerable) * Nov. 2000
Weiss	+	Feb. 1999 (vulnerable) Dec. 2000

Legend

vulnerable = Signifies the time when the rating agency first identified the insurer as a vulnerable insurance company during the period, according to its ratings definitions.
* = Denotes more than one rating action taken during the month.
+ = Indicates no separate watch or review action taken.

Comments by the Rating Agencies on Reliance and Fremont

We obtained information from A.M. Best, Fitch, Moody's, Standard & Poor's, and Weiss concerning their actions on five selected insurance companies involved with the failed Unicover venture. Generally, the rating firms presented similar rationales for their rating determinations on these insurance companies for the period of February 1999 through January 2001. In the cases of Reliance and Fremont, the companies experienced a number of downgrades from all five rating agencies in part because of their involvement with the Unicover-related reinsurance transactions. Another insurer, Cologne Life Re, received a capital infusion by its parent organization and was not downgraded by the rating agencies. Similarly, the rating firms generally did not take downgrade actions against Phoenix Home Life or Sun Life of Canada. Both of these insurance companies were deemed sufficiently capitalized to cover anticipated losses from the failed Unicover venture. The information presented in the following sections provides additional comments on each rating firm's rationale for actions taken on Reliance and Fremont.

A.M. Best

Officials from A.M. Best said they learned of the Unicover-related problems in February 1999 when Cologne Life Re was preparing to take a charge on its year-end 1998 financial statements as a result of its W/C carve-out reinsurance activities. A.M. Best officials told us that they were in immediate dialogue with the insurance companies involved in the matter and had numerous private discussions with the insurers as the Unicover story continued to unfold. Two of the five companies we reviewed that were tied to the Unicover venture—Reliance and Fremont—received a series of rating downgrades by A.M. Best. However, A.M. Best officials mentioned that Unicover was not the principal problem for either insurance company, as both insurers had experienced underwriting losses on key aspects of their insurance business activities.

Concerning Reliance, officials from A.M. Best explained that, although Unicover wasn't their biggest problem, Reliance could not afford to wait long to settle disputes associated with the Unicover-related business because it had limited options for raising capital. Reliance's parent organization, Reliance Group Holdings, Inc., was experiencing a depressed stock price, which meant Reliance could not access public markets for capital. Furthermore, their business reputation suffered as problems emanating from Unicover "cast a spell" over the insurer in the eyes of investors.

A.M. Best placed Reliance under review with negative implications in October 1999, mentioning the insurer's involvement with Unicover as well as concerns over the adequacy of its capital and limitations on its financial flexibility.[13] These concerns were tied to financial problems the holding company, Reliance Group Holdings, Inc., was having, particularly in its ability to pay or refinance hundreds of millions of dollars of debt maturing in 1999. A.M. Best estimated that the magnitude of Reliance's settlement with other insurance companies tied to the failed Unicover venture would be in the $100 million range. In January 2000, Reliance announced that it had settled with other insurers on the Unicover-related losses for $110 million. In February 2000, A.M. Best upgraded the review outlook on Reliance from negative to developing implications, on the basis of the Unicover settlement and favorable capital raising developments, including the possible purchase of Reliance by Leucadia National Corporation (Leucadia). In June 2000, A.M. Best downgraded Reliance from A- to B++. Officials from A.M. Best mentioned that they received Reliance's March 31, 2000, financials in April that showed poor performance and subsequently had meetings with Reliance in May that confirmed their concerns. Part of the downgrade was based on decline in the market value of equity stockholdings in both Reliance and Leucadia and concerns that the potential acquirer, Leucadia, would not buy Reliance due to such market reaction. In July 2000, A.M. Best issued another downgrade on Reliance from B++ to B because of its weak financial condition, an inability to generate new business as it continued to sell off

[13]Before placing Reliance on review, A.M. Best removed the positive outlook from Reliance's "A-" rating in June 1999 after the insurer announced a reserve charge and a decline in its surplus—a situation related to the lawsuits by Unicover pool members for Reliance's role as a fronting company. In August 1999, A.M. Best affirmed this rating.

its assets and operate in runoff mode,[14] and Leucadia's decision not to acquire Reliance. This downgrade placed Reliance in A.M. Best's "vulnerable" category for insurance companies. A.M. Best downgraded Reliance again in August 2000 from B to C, citing a continued deteriorating financial condition as Reliance continued to sell assets and operate its insurance operations in a runoff mode. Subsequent downgrades in December 2000 (from C to D) and January 2001 (from D to E) resulted from ongoing financial problems of the holding company and additional regulatory control over the insurer. The Pennsylvania Department of Insurance issued an Order of Regulatory Supervision on Reliance in January 2001.

Regarding Fremont, A.M. Best officials explained that the insurance company was experiencing negative underwriting results on its core business activities, not just Unicover itself.[15] Fremont's principal problem was that it was underpricing its W/C insurance coverage, pursuing a business strategy of expanding market share at a time when the W/C market was soft. Such activities suggested that the firm did not have proper risk management controls in place. Again, A.M. Best officials emphasized that Unicover, in and of itself, would not likely have resulted in a downgrade. Rather, Fremont's involvement in the failed Unicover venture along with other negative trends that converged at the same time resulted in downgrade actions.

A.M. Best placed Fremont under review in August 1999. Following reported losses on its W/C business and a $150 million pretax reserve strengthening charge for 1999 by the holding company, A.M. Best downgraded the Fremont group of insurers to B++ in March 2000. In August 2000, A.M. Best downgraded Fremont again from B++ to B, identifying the insurer as vulnerable. In December 2000, A.M. Best downgraded Fremont from B to E, signifying that the insurer was under regulatory supervision since the holding company had entered into an agreement with the California Department of Insurance granting significant regulatory control over Fremont's operations as a result of its weakened capital position.

Concerning the other three insurance companies we reviewed, A.M. Best did not downgrade them as a result of their involvement in the Unicover venture. After Cologne Life Re disclosed its $275 million charge in February 1999, A.M. Best put the insurance company under review. However, A.M. Best officials were confident that the parent organization (General Reinsurance Company) would support Cologne Life Re's estimated loss exposure resulting from the Unicover-related reinsurance transactions. Phoenix Home Life was also in a strong cash position and was able to raise an additional $300 million to cover losses that might arise from its involvement in Unicover. Although the Unicover-related endeavor presented some significant losses, it was a relatively minor problem for the company in terms of its overall financial health, according to A.M. Best officials. Sun Life of Canada, which continues to receive A.M. Best's highest rating, was in a similar position as Phoenix Home Life, because it was more than adequately capitalized to withstand the anticipated Unicover-related losses. Additionally, both

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[14]Runoff refers to the situation in which an insurer is not writing any new business but continues to pay claims on policies already issued with its remaining assets.
[15] Fremont Compensation Insurance Company is one of several insurance companies belonging to Fremont Compensation Insurance Group.

Phoenix Home Life and Sun Life of Canada had extensive retrocessional protection from financially sound reinsurers with "massive" amounts of capital and earnings power to cover any Unicover-related losses.

Fitch

Fitch reported a series of downgrades on Reliance and Fremont since the Unicover-related business came to light in February 1999. The involvement of both Reliance and Fremont with Unicover was a contributing rather than a sole factor for downgrades of these companies. Fitch downgraded Reliance five times between February 1999 and January 2001. Fitch officials cited Unicover as one of the contributing reasons for its initial downgrade of Reliance. Other reasons for the initial downgrade included the decline in the market value of Reliance's assets as well as concern about the holding company's ability to make its debt payments and the possible need of the insurer to sell off assets to meet near-term capital needs. Subsequent downgrades resulted from a continued erosion of the insurer's value from asset sales; an inability to conduct certain business activities, such as commercial insurance and reinsurance; the failed acquisition for Reliance; and the need for more regulatory supervision. Fremont was not rated by Fitch until January 2000, and thereafter received four rating downgrades partially due to its involvement in Unicover.

Fitch reported that it placed Reliance on a rating watch with "negative" implications in June 1999 in response to a Reliance announcement that it would likely need to make a $150 to $200 million reserve increase. The company subsequently announced a charge of $330 million in August 1999 and that it was exploring options to restore its capital position, including asset sales. In November 1999, Fitch downgraded Reliance from A+ to A- for three reasons—a decline in market value of its stock portfolio, maturing debt obligations of Reliance's holding company that could require the sale of valuable assets, and Reliance's role in the failed Unicover venture. Fitch maintained its rating watch with negative implications to reflect the risk that the ratings could further decline if Reliance was unsuccessful in raising capital or if the reinsurance contracts to which Reliance was party resulted in significant losses. In January 2000, Reliance negotiated a settlement of its disputes with other reinsurers and recorded a $100 million charge to earnings. In March 2000, Fitch changed its watch status to "evolving" when Reliance announced the sale of its surety business and maintained this status when Reliance agreed to be acquired by Leucadia in May 2000. In June, a competing rating agency downgraded Reliance, making it more difficult for Reliance to compete for reinsurance and other commercial business. Additionally, it began to appear less likely that Leucadia would complete the acquisition of Reliance. Thus, Fitch changed its rating watch to negative. Later that month, Reliance announced the sale of two additional segments of its operations. In response to Reliance's further financial weakening and the increasing doubt about the Leucadia acquisition, Fitch lowered Reliance's rating from A- to BBB in June 2000. Two additional downgrades, from BBB to BB- then to B, occurred in July 2000 related to the cancellation of the Leucadia transaction. The drop to BB- moved Reliance from a "secure" into a "vulnerable" category. Then, in August 2000, Fitch lowered Reliance's rating from B to DDD after Reliance announced it would have to obtain regulatory approval before executing certain transactions.

Regarding Fremont, Fitch did not rate the insurer until January 2000, assigning it an initial rating of A. Though not placed on a rating watch, the initial rating was issued with a negative outlook in consideration of Fremont's losses in the W/C business. Shortly thereafter, Fitch downgraded Fremont to A-, citing a $49 million charge taken by Fremont for its participation in the Unicover-related business as well as non-Unicover related charges totaling $100 million, mostly in connection with adverse reserve developments from its W/C business. In May 2000, Fitch lowered Fremont's rating from A- to BBB+ after Fremont reported losses in the first quarter of 2000. In August 2000, Fitch further reduced Fremont's rating to BB-, amid concerns about marketwide W/C results and possible additional adverse impacts to Fremont's loss reserves. In December 2000, Fitch lowered Fremont's rating to DDD when Fremont announced the California Department of Insurance would be increasing regulatory oversight of Fremont's operations.

Fitch did not take any watch or downgrade actions against Phoenix Home Life or Sun Life of Canada. Fitch noted that Phoenix Home Life had disputed exposures for certain contracts tied to the Unicover venture. Ultimately, Fitch determined that the insurer's Unicover-related charges were not significant enough to warrant a rating downgrade action. Similarly, the Unicover-related charges taken by Sun Life of Canada were not deemed significant enough for Fitch to change its rating. Fitch did not rate Cologne Life Re between February 1999 and January 2001.

Moody's

Moody's learned of the Unicover debacle in February 1999, when Cologne Life Re was taking actions to recognize a $275 million charge on its year-end 1998 financial statements as a result of its involvement in W/C carve-out reinsurance business. Shortly thereafter, Moody's published a Special Comment Report on Unicover, the first of three such research papers on the issue.[16] [17] [18] Moody's officials mentioned that after learning of the players in the Unicover venture, they began to contact insurers and inquire about their involvement in Unicover. They explained there were fundamental issues concerning the quality and timing of the information received from the insurers and a lot of confusion over who was ultimately exposed. Hampering the ability to understand the insurers' actual exposures was the lack of available documentation on the Unicover-related business and a lack of understanding among the insurance companies as to what had happened. Many insurers were unaware of their involvement in Unicover at all or did not understand exactly where they fit in the levels of reinsurance transactions. Additionally, delays in receiving reports of reinsurance transactions exacerbated the problem of determining an insurer's potential exposure because such transactions can be consummated with the financial reporting of the transactions occurring at a later date.

[16] *A Pool and Its Money Are Soon Departed: Turmoil in Workers' Compensation Reinsurance*, Moody's Investors Service, Special Comment Report, March 1999.
[17] *The Unicover Facilities – Can The Principal Parties Find a Way To Turn A Mountain Back Into A Molehill?*, Special Comment Report, Moody's Investors Service, December 1999.
[18] *Unicover Revisited: A Mountain Turned Into A $1 Billion Molehill*, Special Comment Report, Moody's Investors Service, March 2001.

Concerning the five selected insurers, Moody's ultimately took a series of downgrades on Reliance and Fremont.[19]

In its first Special Comment Report in March 1999, Moody's identified several problematic issues related to the Unicover-related transactions. Among the issues presented was the need for pool participants and retrocessionaires to be vigilant about the type of reinsurance business received through a reinsurance pool. In the case of Unicover, insurance companies reinsured a specialty insurance business at a time of depressed primary pricing. Another concern raised was the lack of expertise that capital providers may have in underwriting the underlying business (e.g., W/C insurance) along with the need to closely monitor the reinsurance intermediary, who is often compensated on the basis of premium volume rather than profitability of the business generated. The report also emphasized the risks associated with multiple levels of reinsurance that distances the ultimate capital providers from the original underwriting decisions. Related to this concern is the speed that the expected underwriting margins can erode through fees and commissions as multiple reinsurance transactions are consummated.

Concerning Reliance, Moody's officials explained that Reliance was in trouble, even without its failed Unicover-related business. As reported by Moody's, a key problem for Reliance was that the holding company had a lot of debt that was maturing at the same time. Also, Reliance had commercial books of business that had not been performing well. While Unicover-related losses were significant, and may have warranted a rating downgrade, these losses in and of themselves would not have caused the collapse of Reliance nor warranted other subsequent downgrades, according to Moody's officials. Unfortunately, the negative impacts of Reliance's core business endeavors converged at the same time that the Unicover-related losses hit. Perhaps the biggest negative impact of the Unicover matter was the loss of reputation or goodwill that Reliance suffered, which prevented it from being able to restructure its debt through a buyout or some other arrangement, according to Moody's officials. Consequently, Reliance was not able to write new business and went into a runoff mode.

Specifically, Moody's placed Reliance on watch status for a possible downgrade in November 1999 and May 2000. On June 2000, Moody's lowered its insurance financial strength rating on Reliance from Baa2 to Ba2 and maintained a watch on the insurer. This action identified Reliance as a vulnerable insurance company. Reliance's rating was lowered again in July 2000 from Ba2 to Ba3 with a watch for another possible downgrade. Factors affecting these downgrades included the Unicover problem, the inability of the holding company to pay its debts, and the fact that Reliance had moved increasingly into a runoff status. In early November 2000, Moody's lowered their rating on Reliance to Caa1 because of increasing losses along with holding company debt that was maturing later in the month.

Regarding Freemont, Unicover was part of the reason for Moody's initial downgrade, according to Moody's officials. They explained that while Unicover-related charges

[19] For additional information on Moody's views, Moody's has a series of publicly available documents.

alone may or may not have warranted a ratings event, the Unicover matter exacerbated other problems of Fremont, including insufficient experience with the insurance Fremont kept through its underwriting practices. Fremont had underpriced W/C business overall and thus was experiencing poor performance on this business.

Moody's had placed Fremont on watch for possible downgrade in November 1999 and took a downgrade action in January 2000, dropping it from A3 to Baa1. In August 2000, Moody's dropped their rating of Fremont from Baa1 to Ba1 and announced a watch for another possible downgrade. This downgrade placed the insurer in the vulnerable category. Moody's dropped Fremont's rating again in November 2000 from Ba1 to B2. Fremont continues to operate under a regulatory agreement with the California Department of Insurance.

Concerning the remaining selected insurers, Moody's did not take any downgrade actions. They put Phoenix Home Life on watch in November 1999 for a possible downgrade, but later confirmed the existing rating of Aa3. Sun Life's rating also remained unchanged at Aa2. Moody's did not rate Cologne Life Re during the period February 1999 through January 2001.

Standard & Poor's

Standard & Poor's officials learned of the Unicover problem shortly after the Cologne Life Re announcement in February 1999. From that month through January 2001, Standard & Poor's took a series of downgrade actions on Reliance and Fremont, eventually identifying them as vulnerable insurance companies. In both cases, the Unicover issue was cited as one of several problems that contributed to the downgrades. Phoenix Home Life or Cologne Life Re were not downgraded during the period of February 1999 through January 2001. Standard & Poor's did downgrade Sun Life of Canada one rating notch during this period, but still identified the company as a "very strong," secure insurance company.

Regarding Reliance, Standard & Poor's placed the insurer in a watch status with negative implications in June 1999 following the insurer's announcement that it might be taking a \$150 to \$250 million pretax charge later in the year. Standard & Poor's advised that it would meet with Reliance management to discuss the implications of such a charge to its capitalization. In August 1999, Standard & Poor's downgraded Reliance from A to A- after Reliance's announcement that it would take a pretax charge of \$227 million after the insurer completed a review of reserve losses. Again in October 1999, Standard & Poor's placed Reliance on watch with negative implications citing concerns on the company's potential exposure to Unicover losses, its ability to improve capital adequacy, and the holding company's ability to refinance its debt obligations. In February 2000, Standard & Poor's reported it was maintaining its watch with negative implications but noted the \$100 million (after taxes) charge with Unicover participants was an important first step in management's attempts to address current financial difficulties. Though Standard & Poor's changed Reliance's watch status in March 2000 to developing implications, it downgraded Reliance in June 2000 from A- to BBB- because of Reliance's asset sales and resultant franchise weakening. In July 2000, Reliance received a third downgrade from BBB- to B due to debt problems of the parent holding company and asset sales resulting in franchise weakening. This rating action placed Reliance in a vulnerable category. In August 2000, Reliance was downgraded from B to CCC due to the termination of a potential purchase by Leucadia, debt problems of the holding company, and poor financial performance. Later that same month, Standard & Poor's downgraded Reliance again to reflect the fact that the insurer was operating under a regulatory supervision agreement with the Pennsylvania Department of Insurance.

Standard & Poor's placed Fremont on watch with negative implications in November 1999 because of concerns about capital adequacy and earnings capacity. In January 2000, Standard & Poor's downgraded Fremont from A to A- over concerns about capital adequacy and financial weakness of the holding company. The next downgrade occurred in May 2000 when Fremont's rating dropped from A- to BBB because of concerns about earnings prospects, reserve and capital adequacy, and financial flexibility of the holding company. In August 2000, Standard & Poor's downgraded Fremont from BBB to BB+ amid continued concerns about earnings, capital adequacy deterioration, and its financial flexibility. Later that month, Fremont was downgraded again from BB+ to BB because of concerns regarding financial performance and capital adequacy. In November 2000, Fremont received a downgrade from BB to R because of increased regulatory supervision.

Concerning the other remaining selected insurance companies, Standard & Poor's did not downgrade Cologne Life Re and Phoenix Home Life. Although Cologne Life Re's $275 million charge related to its Unicover-related losses would have rendered it insolvent, its parent organization, General Reinsurance, provided sufficient capital to Cologne Life Re to withstand the losses. Phoenix Home Life also was not downgraded because it was more than adequately capitalized to withstand its Unicover-related losses. Sun Life of Canada received a downgrade from AAA to AA+ in August 1999, although the Unicover issue was only one of several factors. Still, Standard & Poor's identified Sun Life of Canada as a "very strong," secure insurance company.

Weiss

Weiss took several rating actions on Reliance and Fremont from February 1999 to January 2001. Phoenix Home Life was slightly upgraded in December 2000, while Cologne Life Re's rating remained unchanged during this period. Weiss did not rate Sun Life of Canada.

Weiss' first downgrade of Reliance occurred in December 1999 on the basis of its June 30, 1999, quarterly financials. The rationale for this downgrade, from C to C- was the net losses and overall poor company performance, because losses had been occurring for a couple of quarters. While Reliance's involvement with the Unicover-related activities was a contributing factor, the insurer suffered poor performance on its core insurance business, according to Weiss officials. In September 2000, Weiss downgraded Reliance again from C- to E+ over concerns that the holding company would not be able to make its debt payments and also could have difficulties in providing additional capital to the insurance organization. Additionally, other concerns were raised in light of the agreement that Reliance made with the Pennsylvania Department of Insurance to seek its approval before making major financial transactions. In December 2000, Weiss again downgraded Reliance from E+ to E- because the insurer failed to meet two debt payments, including a payment that was extended from March 2000. The Weiss official we contacted mentioned that the rating agency contacted the Insurance Department to confirm what had been reported in the press about the agreement.

Weiss downgraded Fremont in February 1999 from C+ to D+ due to underwriting losses partially due to its involvement in Unicover, but more importantly due to decreases in assets and capital surplus. This rating action identified the insurer as a vulnerable insurance company. In June 2000, Weiss issued a U rating on Fremont due to the lack of data for the year-end 1999. Later in December 2000, Weiss downgraded Fremont to an F rating to indicate it was under increased regulatory control, operating under a supervisory agreement with the California Insurance Department, with the Unicover-related losses as a contributing factor.

Rating activities on other selected insurers were relatively minor or unchanged. Weiss upgraded Phoenix Home Life slightly from B- to B in December 2000 and left Cologne Life Re's rating unchanged due to a capital infusion by its parent organization, General Reinsurance. Weiss did not rate Sun Life of Canada during the period of February 1999 through January 2001.

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