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Book Review

History of company's collapse

by Anthony B. Richter

Broken Promises: The Inside Story of the Failure of Executive Life by Vic Modugno. Published by Pacific Insurance Press, Torrance, California, 1992, 208 pp. $24.95.

When highly qualified candidates from traditional life insurance companies applied for an actuarial position at Executive Life (EXL) in the 1980s, the odds were that the EXL management would view them as lacking in flexibility. To EXL's management (mainly CEO Fred Carr and his consulting actuary, Al Jacob), "flexibility" meant operating "at the extreme edge of the gray area between legal and illegal." This flexibility, along with innovation, a quick "time to market" for new products, and a massive investment in junk bonds (which at one time were as much as 60% of total assets), propelled EXL to a compound growth rate in assets of 50% per year during the late 1970s to 1989. This compares to 5% for the life insurance industry as a whole during this period.

Vic Modugno, FSA, survived in this helter-skelter environment from the time of his hiring in May 1986 to April 1990, when he left shortly after the junk bond market crashed, and "the debt party was over." The core of this book is a history of EXL from the early days (it was founded in 1961 by a group of Southern California insurance agents) through 1974, when Carr became president and then CEO. It moves on through the wild years of growth to the end in 1991 when EXL went into conservatorship, and security guards escorted Carr out of the EXL corporate headquarters and confiscated his car.

Besides being a history of EXL and its well-known subsidiary, Executive Life of New York (EXLNY), the book has well-written and informative sections on the economy of the late 1970s through 1991. They cover the life insurance, annuity, and pension business; state insurance department regulation; the reinsurance business, especially modco and surplus relief insurance; field compensation; auditing; consulting; tax reform bills of the 1980s; the vagaries of statutory accounting; and last, but by no means least, the magic of junk bond financing. (EXL was the largest purchaser of Michael Milken's junk bond offerings.)

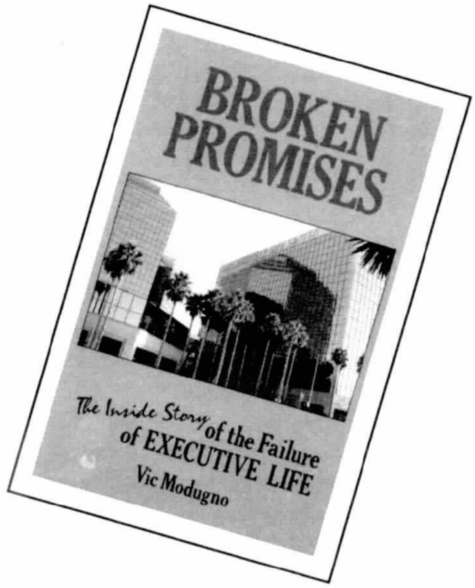
Most of the book consists of anecdotes and personal observations, many of which some readers may find to be of questionable taste or judgment. The book also is marred by sloppy editing and frequent grammatical and spelling errors. In one such situation, the word "trance" is used incorrectly several times for "tranche," which means a slice or a portion of a bond issue. The author, who had a love-hate relationship with EXL, has strong, mostly negative, feelings about many things, and he is not shy about expressing them. He also tends to pepper his prose with rumors. Except for certain technical sections, such as the chapter on pensions, the breezy and gossipy quality of his writing makes for entertaining reading.

With a book like this, it probably is better to let the author speak for himself, and let readers make of it what they will.

> *By 1986, Executive Life had grown to $10 billion in assets and 1,000 employees. Yet it was still being run by Fred Carr by the seat of his pants like a small company.* (page 53)

The author delights in comparing EXL with his earlier employer, Metropolitan Life, and other large mutual life insurance companies:

> *Metropolitan Life had an employees' lunchroom, a supervisors' lunchroom, a managers' lunchroom, and an officers' dining room. The officers had two luncheon shifts — one for senior officers and one for junior officers. The officers' dining room had waitress service while the other levels were cafeteria style.... At Executive Life, everyone, including Fred, ate in the cafeteria.* (page 55)



> *At most insurance companies, attorneys are naysayers, telling the marketing and product development people what they could not do. At Executive, both the general and the tax counsel were developing insurance products.* (pages 47-48)

> *Executive's management was willing to exploit marketing opportunity and to introduce innovative products immediately. Most large companies had become so bureaucratic that they could take years to implement a new product...if their entrenched ultra-conservative managements could be induced to approve anything new.* (page 21)

> *...Most large mutuals hide huge amounts of statutory surplus in reserves. This minimizes taxes and is also consistent with the very conservative way in which these companies are managed. Their actuaries like to set up reserves to cover every conceivable contingency. If Metropolitan had set up reserves (when I was there) on the same basis as Executive Life, they would have many times the amount of surplus.* (page 194)

Consultants came in for their fair share of the author's scorn:

> *There are many incompetent consultants in the pension business. They seem to get employment primarily in public employee*

or charitable groups where there is less financial sophistication and concern. (page 74)

The author marvels at the intricacies of the EXL marketing system and the greed of anybody who had anything to do with it:

Some large (pension) cases had so many individuals sharing the commission that we would refer to the master agent as a "bag man." (page 69)

...The agents saw the potential commissions to be made in group annuities. Total life insurance company group annuity premium from plan terminations already exceeded $6 billion per year. Applying a 10% commission rate to that would produce $600 million. Not bad for taking orders! (page 77)

He saves his greatest contempt for state insurance departments and the people who work in them:

New York attempts to do the most thorough regulation of any state.... New York and New Jersey together have more actuaries working in the state insurance department than the remaining 48 states combined. The New York Department (NYSID) is an extension of the large mutual companies domiciled in the state — Metropolitan and Equitable. The Prudential...dominates the New Jersey Department. (page 159)

The NYSID acted much like the Japanese Ministry of Trade in cooperating with local companies to promote informal unwritten barriers against foreign "devils." (page 168)

You would think that NYSID would be thrilled to have consumers within New York getting a bargain on insurance and annuity products. Instead the department would jump on any company that dared to underprice the inefficient, bloated mutuals dominated in that state. (page 161)

The author stresses this last theme in describing the years leading to the downfall of EXL. He uses Regulation 126 on cash flow testing to make his point:

NY 126 was developed by a task force of actuaries from Metropolitan and other New York mutuals.... The regulation was complex, over 100 pages long, and reflected the (Asset/Liability) management practices of large mutual companies like Metropolitan. It also gave the NYSID broad authority in setting the assumptions and in deciding to approve a submission. If they did not approve, substantial additional "penalty" reserves would have to be set up. (page 163)

Many small companies could not afford to do the study (which would be needed to prepare a NY126 submission) for which consultants might charge $100,000 or more and chose to set up penalty reserves instead. As you might imagine, they would not be too aggressive in writing more of this business, thus limiting the competition. (pages 164-165)

The author claims that the NYSID tried to force EXLNY into statutory insolvency "by specifying unrealistically low interest rates and high default rates" and by other unrealistic assumptions. He further states, "NYSID was clearly prejudiced against EXLNY and would reject any study that proved solvency." Eventually, EXLNY hired a consultant at a cost of $126,000 per study, who was able to "object when the NYSID was making unreasonable demands...compared to what it approved for other companies."

After the failure of the United Airline buyout in fall 1989, the junk bond market began to decline. S&Ls were beginning to sell their junk bonds because of a new rule that forced them to mark these bonds to market. The decline snowballed, and by February 1990, "streams of policyholders were coming into the Executive Life Center (in west L.A.), policies in hand, seeking to cash in before it was too late." The panic did not last long, but things only got worse as 1990 wore on.

The junk bond market continued to nosedive, and after Iraq invaded Kuwait in August, the recession was obvious. Standard and Poors (S&P) and Moody's both put EXL on credit watch with negative implications. The stock went from a high of 17 in 1989 to 7 in mid-January. After S&P downgraded EXL's rating from AAA to A, and Moody's, from a1 to Baa2, the stock fell from 7 to 3 in one day. Even so, EXL managed to last another year until the California State Insurance Department took it over.

In the author's opinion, one of the ironies of the EXL situation is that the company actually was stronger in 1990, when the roof began falling in, than it was in 1983, before its phenomenal years of growth from $4.8 billion in assets at year end 1983 to $19.3 billion at year end 1989. One of the points in a Senate hearing chaired by Sen. Howard Metzenbaum (Ohio) was that without its various surplus relief reinsurance treaties, EXL was technically insolvent in 1983. With all its surplus relief treaties disallowed in later years, EXL might have survived, even with its high percentage of junk, if the default rate on these bonds stayed at historical levels and the bonds held to maturity.

EXL had a combination of policies with cash values subject to immediate withdrawal (e.g., life insurance) and policies for which cash would be paid out over many years into the future (GICs, SPDAs). EXL had enough funds to pay the demand deposits, but the regulators believed the long term was jeopardized because of the uncertainties of junk bonds. This was the single biggest factor leading to the state takeover.

One final quote from the author sums up his view of the whole situation:

Had (EXL) played it completely straight, everything might have worked out. But they did all kinds of sneaky and dishonest things...as is true with the corporate raiders and the entrenched managers they sought to displace, it's hard to tell which group of scoundrels is worse.

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Searching for U. of Conn. alumni

A new Executive Alumni Committee for Actuarial Science is compiling a mailing list of all University of Connecticut alumni in the actuarial profession. To be included on the mailing list and to find out how fundraising activities will benefit the actuarial science program, send your name, address, and telephone number to Charles Vest, The Travelers, One Tower Square, Hartford, CT, 06183-6030.