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EIR Economics

Junk debt brings down insurance industry

by Chris White

Policyholders owed about $80 billion in benefits are chief among those on the receiving end of the latest phase in the collapse of the U.S. credit structure. The $80 billion is the approximate total of the liabilities owed by insurance companies seized by California's State Insurance Commissioner John Garamendi, and the commissions in the states of New York and Virginia. On May 10, First Capital Insurance was seized, its $31 billion in liabilities adding to the near $50 billion in liabilities of the already seized First Executive Life. On May 14, Virginia took action against the company's subsidiary in that state.

The surfacing collapse of insurance companies around the country is to be added to the destruction of the farm sector during the 1970s, the early-1980s wreckage of the savings and loan institutions, the mid-1980s usurious destruction of corporate America through the asset stripping and merger wave, and the in-progress collapse of the banking system. Bubble and bust, bubble and bust. The pattern established on the broken back of farmers, lured into borrowing on the basis of the sevenfold run-up in the book value of their land which was organized during the 1970s, and who were then bankrupted as land values collapsed, has repeated itself. The insurance companies are the latest corpse. Until the overall, still growing, nominally valued $16 trillion of tangible property and land values in the country is brought back to realistic levels, they won't be the last.

Casualty, life, and health insurers are regulated at the state level. Such companies have been backed, since the 1970s, by a guaranty fund, safety net-type operation, under which companies pool resources to cover claims against their failing colleagues. The guaranty fund, reportedly, can cover about $3 billion per annum out of such means. The National Association of Insurance Commissioners has identified another 18 large insurance companies which have 30% or more of their assets tied up in the junk bonds which wrecked First Executive and First Capital. We must assume then that the liabilities of the $1.35 trillion in nominal assets of the insurance industry are no better covered than were depositors in the wreckage left by the debacle of the S&Ls, or those commercial bank depositors supposedly covered by the now insolvent Federal Deposit Insurance Corp. Pension plans and related types of insurance coverage are about to turn out to be worthless.

Garamendi's actions to put these companies out of business are doing the country a certain service. Federal regulators and government officials, in this administration, and the last, have been conniving with the financial crowd to loot corporate and other pension plans, and to cover up the real state of affairs. Garamendi's seizures draw attention to this in a way nothing else has seemed to so far. Pension plan assets were part of the loot targeted in the insane takeover wave of the late 1980s. Such assets were stripped out to finance debt assumed in the asset-grabbing wave, and replaced with annuities and so-called guaranteed income contracts which were backed, in their turn, by the debt service stream returning to holders of bonded debt issued to finance the takeovers.

Rewriting pension plan guidelines

The specter of more worthless paper is already prompting another round of coverup. For example, the Department of Labor, which has administrative responsibility for some em-

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ployee pension plans, is now in the process of rewriting its fiduciary guidelines for employers and other sponsors of pension plans. An advisory council named by the department found, according to the May 10 *Journal of Commerce*, "that many pension plans invested with unrated insurance companies and purchased the cheapest product available." This is something of an understatement indeed. Pension fund assets have been stripped for cash, and beneficiaries left with what will shortly turn out to be worthless paper. Sen. Howard Metzenbaum (D-Ohio) reported this during a congressional hearing—talk about shutting the stable door after the horse has bolted.

Additionally, new guidelines for capital adequacy of the companies are being adopted by the state regulators. Pioneered in California, the practice, whereby companies have been permitted to count policies reinsured with reinsurance companies as capital rather than as liabilities, is to be outlawed. Some 60% of First Capital's capital was made up of such policies, helping the company appear solvent when it was not.

The new ruling will take effect at year's end, and will certainly "chill out" the junk investments in the industry. But it will "create chaos," according to one actuary, as many companies will become insolvent overnight.

Such actions ensure that, as with the case of the S&Ls and then the commercial banks, the bankruptcy of insurance will not be pushed under the rug, but will continue. Immediately, there are further chain reaction effects spreading through the country's financial institutions as a result of the seizures in California and other states. These too are certain to eventually bring the matter of the missing, and unfunded pension liabilities to the fore in the most explosive way.

Fraud charges in the air

Among such effects are runs developing against insurance companies by policyholders anxious to cash in policies before the companies are put out of business. There was a tenfold increase in such activity before Garamendi issued his cease and desist order against First Capital. Then there are added problems for banks and financing agencies. Citicorp's banking subsidiary, Citibank, was the leader of a loan syndicate which had put together $221 million for First Capital. Garamendi's "cease and desist" order was designed in part to protect policyholders against Citibank's efforts to force First Capital into voluntary bankruptcy. Owned by Shearson Lehman, the order also forces parent company American Express to write off its stake in the insurance company, while potentially exposing the company to fraud charges. Shearson Lehman phone marketers were aggressively marketing the company's policies until the last minute.

And thirdly, the big one: Action against First Capital prompted the eruption of fears that junk bond holdings worth billions of dollars would be unloaded, potentially bringing down everything in their wake. Indeed, the failures now surfacing in the insurance companies are part of a broader pattern of junk bond-related defaults and liquidations. Canada's Belzberg family, part of the Michael Milken funders' pool, has defaulted on some of its obligations. Gaylord Container from Chicago is also entering into default. Shark Carl Icahn, who took over the airline TWA, now threatened with bankruptcy, wants to buy back the debt issued to finance the takeover at 17¢ on the dollar. He tells his funders, it's a better deal than bankruptcy would be. And, financial cult leader Warren Buffett has supposedly been quietly liquidating his holdings of RJR-Nabisco bonds, among others.

Debt doubled twice since 1975

The junk bonds now cascading into defaults were part of the debt accumulation built up since especially 1982. By the end of 1990, the sum of credit market borrowings, or the total indebtedness of the U.S. economy for all borrowers, could be estimated at about $14 trillion. The basis for this estimate is provided by the Federal Reserve's "Flow of Funds" data series. Of this total, federal, state, and local governments account for more than $5 trillion, households for $3.8 trillion, and businesses, financial and non-financial, for another $5 trillion. This is about $50,000 of debt per capita; the amount has doubled twice since 1975, while the national average wage has doubled once. Agriculture, industry, infrastructure, and technological development have been stripped out to maintain the claims of the growth of debt.

The growth of debt wasn't secured against any growth in national wealth, which is achieved through increasing the productivity of labor. Just as with the artificial inflation of farmers' land prices in the 1970s, the growth of debt has been secured against an artificial and fictitious appreciation of the so-called assets which are used as collateral for the debt. The same Federal Reserve claims that the net tangible reproducible assets of the country, along with the land, come to about $16 trillion—if this were divided among all citizens, then each would have a nest egg of some $60,000 to salt away. Of the $16 trillion total, the market value of residential properties represents one-quarter, the market value of land another quarter. This mass did not increase as fast as the debt, but its increase did generate what the takeover wolves like Milken used to call the "locked-in" or "hidden assets" of companies targeted for takeover. The run-up in the valuation of tangible and reproducible assets was supposed to be a part of the assurance that, however much debt was incurred to finance takeovers, it could always be covered out of the liquidation sale of such assets.

There was only one problem. None of the run-up was real. The physical depletion of basic economic infrastructure, depletion and disinvestment in plant and equipment, and scrappage of whole sections of the work force and population, is evidence that there has been no improvement in tangible assets to back up this so-called growth in assets. Insurance policies and pension plans are the latest to be ground up in that squeeze. But they will not be the last.