WHO KILLED CONFEDERATION LIFE - The Inside Story

By Rod McQueen

Book Review by Conrad M. Siegel, F.S.A., United States of America

Personal Prologue

When this book was brought to my attention, I immediately obtained a copy and read it in one sitting. I had substantial personal interest in the subject as a Confederation Life policyholder in two countries, in two currencies, and in two life stages. The first was a \$C10,000 policy bought on my life as a child by my father, but still in force more than 50 years later. The second as an employee nearing retirement in a defined contribution plan which invested part of its assets in a Confederation Life GIC (guaranteed investment contract) in U.S. dollars.

Canada, with a small population, is a major exporter of life insurance, especially to the neighboring United States. State insurance laws require the choice of a state to be the state of entry and that assets backing up United States liabilities remain in trust in the United States. Furthermore, the insurance commissioner of the state of entry requires an annual filing in great depth and the insurance commissioners of other states in which the company does business participate in the examination headed by the state of entry. Confederation Life was founded in 1871 and, with assets of \$C19 billion was the fourth largest insurance company in Canada.

Confederation Life entered the United States in Michigan and established a United States head office in Atlanta, Georgia and developed a market in individual life insurance including corporate owned life insurance and bank owned life insurance, individual annuities and annuities used to underwrite "structured settlements" of negligence suits involving accidents and medical malpractice. GIC's for employee funds produced a significant level of premium income. In general, the producers of this business were brokers, rather than career agents and, in fact, the brokers often were part of large producing organizations.

When I qualified as an actuary in the 1950's, there was substantial cross-border actuarial migration activity between the United States and Canada. The examinations to become a Fellow of the Society of Actuaries were not country specific and there was a fair amount of migration from Winnipeg and Quebec to Ontario and a fair amount of migration from all parts of Canada to the United States. Canadian insurance companies were well staffed with actuaries (my employer had 13 actuaries and total assets of $C45 million), and the number of actuaries per million of population in Canada at that time was about twice that of the United States. The safety of Canadian life insurance companies was assured, given the fact that no major life insurance company had ever failed in Canada. As an actuary, I took pleasure in attributing it to the fact that in Canada actuaries were always made a part of top management and frequently served as CEO. Furthermore, strong federal regulation of insurance in Canada was under the "Superintendent of Insurance," a position frequently occupied by an actuary.

My employer's purchase of the GIC contract was buttressed by AAA ratings from Standard & Poors and A+ ratings from A.M. Best. In addition we believed ourselves to be fully protected by the Pennsylvania Life & Health Insurance Guaranty Corporation which maintains a $5 million coverage on GIC contracts, an amount substantially larger than our contract. At about the time of our purchase I happened to have dinner with the actuary who headed the Confederation Life's United States branch and asked him his opinion of the purchase of a GIC from Confederation Life and received his complete assurance. And, of course, we were in very good company with major pension managers such as Fidelity Investments and CoreStates Bank who also purchased much larger GIC's from Confederation Life. In many cases these pension managers received assurance from specialized consulting firms of actuaries whose function was to perform due diligence with respect to the GIC purchases.

Our particular contract was a five-year contract at an interest rate not much above U.S. government bonds and one of the principal reasons for purchasing a GIC as part of the fixed income component of a defined contribution plan is the assurance of stability of market value for purposes of reporting participant accounts each year.

We received our interest payment in 1992 and in 1993 and began to notice disquieting news in the *Wall Street Journal* concerning efforts by Confederation Life to be acquired or helped in some fashion by Great-West Life, another major Canadian insurer with multi-national business.

The announcement that Confederation had gone into receivership in Canada and under "rehabilitation" in the United States on August 11, 1994, was like a bolt out of the blue.

<u>The Book</u>

McQueen is a journalist who has had extensive experience as a financial journalist as the author of a number of books in Canada, the United States and in the United Kingdom.

His book reads very well and I am assured by an actuary friend in Canada, a disinterested observer, the book is quite accurate. It is well written and reminds me somewhat of two other books I have read on major corporate financial disasters-one on R. J. Reynolds and the other on Prudential Securities. A book written on a life insurance disaster (about Executive Life) by an actuary is also interesting but does not appear to be well edited and could have benefited from a journalist's skills.

McQueen traces the company from its founding in 1871 and its conservative management by three generations of its founding family. In 1968, following the trend of other stock companies, it became a mutual company.

The company had very strong actuarial input over the years and, in fact, a longtime CEO who preceded the "villain" of the piece was an actuary. The villain, Pat Burns, joined the Confederation Life straight from high school without the benefit of a university education or a professional qualification. He rose from premium accounting clerk through data processing through group insurance marketing, in each case being at the right place at the right time. He became CEO after an interim CEO who had retired from another company was elevated to Chairman.

He was imbued with an expansionist policy which was reinforced by a fellow executive with grandiose schemes to get into other fields and other countries. The expanded areas included establishment of a leasing company in Canada, equity real estate investments in both Canada and the United States, and establishment of a bank in the United Kingdom. In most cases there were inadequate controls and untested management.

At one point there were more than 60 companies in the corporate structure. One particular company, Confederation Treasury Services Limited, invested the short-term funds on a multi-national basis. This innocuous sounding organization, upon discovering short-term financial problems in Canada substituted its own notes for U.S. assets in trust, thereby defeating the purpose of maintaining U.S. assets to cover its U.S. liabilities. While the Michigan insurance commissioner was apparently asleep at the switch when this was occurring, he had no problem in suing the U.S. trustee bank and the big six accounting firm for their alleged negligence in allowing this to happen!

Another problem was the decision to build a "Taj Mahal" new home office building at a cost of $C90 million at a time when real estate in Canada was tanking. This magnificent structure is described by its designer as "a uniquely Canadian architectural expression firmly rooted in the history of Canada. It evokes memories of our Parliament Buildings and the original CPR chateaux built shortly after Confederation and in essence the very symbol of Confederation. The apex of the site is crowned with a turret, in scale with and reminiscent of the traditional mansions in nearby Rosedale to the north. The base of the of lice component on the west facade has a grand scale, although still human; the sixty-feet-high base creates a grandeur appropriate to the entrance and 'front door' of this major Canadian head office." The office building was later sold for one-third of its cost.

The efforts in 1994 to rescue Confederation Life are documented in detail by McQueen. Apparently Great-West Life was the "winner" in being selected to do the rescue. Great-West, however, spent a great deal of time in due diligence and ultimately rejected its role. The remaining major insurers in Canada, pleading lack of time put together a package requiring government concessions and suggested that the Federal government treat Confederation Life as "too big to fail." No rescue package resulted.

The fateful day of August 11, 1994, resulted from the new CEO and the federal regulator coming to the conclusion that a "run" on the company's policies was about to occur as the rating agencies belatedly began to reduce their ratings and as major brokerage organizations began to become concerned with their sale of new policies.

The rescuer brought in by the Michigan Department was the well-known Victor Palmieri. Palmieri had had involvement in many major bankruptcies including Pennsylvania Railroad and Mutual Benefit Life and this Confederation problem was a classic example of Palmieri's laws. The six common elements that inflict all troubled companies, whatever their size, are worth repeating:

- The law of collective incompetence: Put a group of successful, experienced, and intelligent businessmen in a paneled room, call them a board of directors, and their individual level of intellectual acuity and moral courage will immediately plummet to the lowest common denominator.

- The law of the visionary leader: The salesman genius who succeeds to top management is almost always too arrogant or too insecure to take financial guidance and too focused on making deals to worry about the balance sheet. Whenever a super salesman, endowed by heaven with a "strategic vision," is put in charge of a financial institution the odds are two to one that the company will be in insolvency proceedings within three years.

- The law of sudden crisis: No matter how great the sense of surprise and shock in the financial community when the crunch comes and the headlines appear, no corporate crisis really happens overnight. It takes years of intensive effort by a determined management to create the conditions for the failure of a major corporation.

- The law of budgets and forecasts: In a turnaround situation, the information presented to a newly arrived CEO is more likely to be part of the problem than part of the solution. If prior leadership had build an honest management-information system, there would be no need for outside help.

- The law of creditor relations: The key to a successful reorganization is making all creditor groups equally unhappy, but not so unhappy that they resort to time-consuming adversarial proceedings. In short, keep them sullen, but not rebellious.

- The law of external effects (California-style): In the end, macro factors tend to swamp micro factors. Earning a living as a corporate crisis manager is a little like big-wave surfing. You can bring in a team of the best and brightest, build credibility with lenders, cut costs, create a perfect plan, and be a charismatic leader, but if the swells of recession are running against you, you're not going to make it to shore before the sharks start circling."

Palmieri further expands on collective incompetence of the board as follows: "In each case, you had a board of highly successful, powerful civic and corporate leaders sitting around a board table in a semi-conscious state so far as the corporate strategies were concerned, and where it was leading so far as the perception of risk was involved. In short [it was] a total failure of prudential stewardship," says Palmieri. "It's another demonstration of the extent to which boards of directors peopled by individuals - who in their own right are successful and even shrewd business people - can, when they assemble in a boardroom, lose 50 per cent of their IQ points over a long period of time."

The board members, for their efforts, were included in the lawsuit against the trustee bank, the auditors and certain officers of Confederation Life. One of the defendants in the law suit was the same U.S. Vice President who shortly after assuring me of the strength of Confederation Life is quoted by McQueen as telling one of his sales vice presidents "I'd be a little careful. I just found something out and we may not be as financially stable as we should be." Then he quickly added, "But don't worry. We'll be all right."

McQueen's summary is as follows: "Directors did not hold management sufficiently accountable; officers acted irresponsibly and with reckless disregard; regulators were tardy to react, then threatened with a stick too small; auditors peered at the books but missed the big picture; weak-willed politicians had neither courage nor conviction; and, rather than help, the industry leaders were reduced to a mere dither."

<u>Personal Epilogue</u>

The Canadian policyholder guaranty organization, CompCorp, within one week of August 11, 1994, called for cash funding contributions by the other Canadian insurers and persons were covered up to their policy limits for life insurance policies with not much disruption. My $10,000 policy is now a Maritime life policy, a subsidiary of the John Hancock. McQueen's book does indicate problems with persons with disability coverage in obtaining claim payments.

The U.S. GIC, however, is another story. The guaranty provisions vary from state to state and the U.S. insurers were unwilling to commit guarantee funds until a global settlement was reached in the U.S.

The carcass of Confederation Life was picked over and the juicier parts were sold off fairly quickly. There was difficulty in getting an insurer to acquire the structured settlement business, which is very long-tail business and is written on a nonparticipating basis generally. Our own GIC faired fairly well and we got most of our money in 1997, a year beyond the maturity date of the policy. The amount of legal and actuarial involvement in the U.S. were immense. Associations of each type of policyholder were formed, often by the very actuaries who had done due diligence prior to purchase of the Confederation Life policies. In the end there was a transfer from the Canadian assets to the U.S. of less than 50% of the CTSL "notes." Lawsuits continue. I had the temerity to write to the Michigan Court with a suggestion and was, by return mail, sent one foot of filings by various lawyers. Palmieri's "law of creditor relations" worked fairly well.

My own conclusions from this experience are that:

1. The Canadian life insurance industry made a serious mistake by not protecting its reputation at a cost that would have been relatively small.

2. The efforts of the major rating agencies are substantially useless, too little and too late. More prescient ratings were supplied by small organizations which were subject to derision by the insurance industry.

3. There is a shortage of very good management. Very good managers can operate across many lines of business (life insurance, property/casualty insurance, stock brokerage, banking, mutual funds) and countries and mediocre management has enough trouble learning how to do business in one field and in one country. There

certainly is not enough margin between life insurance assets and liabilities to take multiple risks in multiple industries in many countries.

4. My employer is not investing additional money in GIC's, regardless of issuer.

5. The executive of a mutual insurance company, earning a salary in the six-figure or low seven figure area looks with longing at his counterpart in a stock insurer enjoying the fruits of stock options and capital gains, resulting in seven figure or eight figure earnings. Confederation Life, a mutual company, was considering de-mutualization towards the end. In fact, the expansionist executive who lead Confederation Life into many of its new and untested areas, personally profited significantly by buying stock in one of the subsidiaries using a loan granted him by the insurance company. Confederation executives also borrowed from subsidiaries to put down payments on condominium apartments on a speculative basis intending to "flip" them at a profit. The flip "flopped" with the cascading realty market, leaving Confederation with an unintended equity investment.

6. The state-by-state guarantee fund coverage in the U.S. is highly unsatisfactory, compared with life insurance guarantee coverage in Canada and bank deposit insurance in the U.S.

7. The actuarial profession did not distinguish itself Many of the "players" within Confederation and outside are actuaries. Actuaries and other executives who devote substantial interest to alcohol consumption don't do well.

The head of the successor to the superintendent of insurance, now called the Office of the Superintendent of Financial Institutions (OSFI), a former auditor who had, in fact, audited Confederation Life had low regard for actuarial opinions.

McQueen quotes him as follows "One of the big problems of the actuarial profession is that they hate giving opinions. Accountants come to a point where they have to fish or cut bait and give an opinion. Tell that to an actuary."

The consulting actuaries did very well financially as interested parties hired actuaries and lawyers to argue about the carcass. The Court's ruling, sent to policyholders, is nearly a complete textbook on life contingencies, formulas and all.

8. Conflicting geographic and multinational staff functions resulted in the U.S. general manager, an actuary, failing to stop the substitution of worthless CTSL notes for U.S. assets.

I would recommend the book to any actuary or insurance executive. It was published in 1996 by McClelland & Stewart Inc. of Toronto, Ontario, Canada.