ELSEVIER Journal of Financial Economics 41 (1996) 475–511

JOURNAL OF Financial ECONOMICS

Perceptions and the politics of finance: Junk bonds and the regulatory seizure of First Capital Life

Harry DeAngelo*[,a], Linda DeAngelo[a], Stuart C. Gilson[b]

[a]*School of Business Administration, University of Southern California, Los Angeles, CA 90089, USA*
[b]*Harvard Business School, Harvard University, Boston, MA 02163, USA*

(Received February 1995; final version received November 1995)

Abstract

In May 1991, one month after seizing Executive Life, California regulators seized First Capital Life (FCLIC). Both insurers were Drexel clients with large junk bond holdings, and both had experienced 'bank runs'. FCLIC's run followed regulators' televised comments that its poor condition necessitated a substantial cash infusion. Yet FCLIC's statutory capital – with junk bonds, real estate, and mortgages marked to market – was far from lowest among major insurers with California policyholders. It becomes lowest if junk bonds *alone* are marked to market at year-end 1990 (ignoring larger market declines in real estate/mortgages and the junk bond market's 21% return in early 1991). Our findings suggest a regulatory bias against junk bonds in the political backlash against the 1980s.

Key words: Politics of finance; Bank runs; Junk bonds; Insurance; Financial distress
JEL classification: G22; G28; G33; G38; L14

*Corresponding author.

We greatly appreciate the invaluable comments of 24 individuals involved in this case, who spoke to us on a not-for-attribution basis. These individuals include management and directors of First Capital, insurance regulators for California, Virginia, and other states, creditors, investment bankers, attorneys, management at competitor insurers, industry analysts and observers, and members of Drexel's junk bond operations. We are also grateful to Edward Rice, Douglas Skinner, René Stulz, Mark Weinstein, finance seminar participants at the Universities of Oregon and Washington, an anonymous referee and the editor, Michael Jensen, for helpful comments, as well as to Samuel Karam, Perikles Konstantinides, Steven Krohngold, and Sharon Sun for research assistance, the California Department of Insurance and Townsend & Schupp for access to data, and the Division of Research at Harvard Business School and USC (Charles E. Cook/Community Bank and Kenneth King Stonier Chairs) for financial support.

0304-405X/96/$15.00 © 1996 Elsevier Science S.A. All rights reserved
SSDI 0304-405X(95)00866-D

'They're out to save us from junk bonds,
but who will save us from the regulators?'
Robert Bland, stockholder, First Capital Holdings

1. Introduction

In May 1991, California regulators seized First Capital Life Insurance Company (FCLIC), an operating subsidiary of First Capital Holdings (FCH), then the life insurer with the greatest percent (40%) of its investments in junk bonds. Seizure was motivated in part by regulators' concerns that FCLIC's weak financial condition had triggered a 'run', as evidenced by a huge increase in customers seeking to surrender their policies or annuities. It followed by one month California regulators' seizure of a larger and more controversial firm, Executive Life Insurance Company (ELIC), whose parent, First Executive Corporation (FE), held more than 65% of its investments in junk bonds. Losses on these bonds had led, in early 1990, to a massive run that further eroded FE's condition before ELIC's April 1991 seizure (DeAngelo, DeAngelo, and Gilson, 1994).

Our evidence indicates that, unlike FE, FCH received scant media attention starting in late 1989 when the junk bond market began to experience problems. Nor did contagion from FE's well-publicized 1990 run have more than a minor impact on surrender demand at FCLIC. Rather, FCLIC's daily surrender requests peaked much later – in May 1991, following California regulators' remarks that FCLIC required a substantial cash infusion to survive. These remarks precipitated a survival-threatening run, which regulators soon thereafter cited to justify seizure. Virginia regulators seized FCH's other major subsidiary, citing a run on that firm in response to California regulators' actions against FCLIC. In less than one month, FCH went from virtually no publicity to 'front page' business news, regulatory seizure, and bankruptcy court, becoming the fourth largest corporate bankruptcy to date (Altman, 1993, App. 1.1).

Our evidence suggests that FCH's collapse was precipitated by regulatory targeting of insurers that specialized in junk bond investments rather than by FCLIC's uniquely poor financial condition. We compare FCLIC's statutory net worth (capital plus mandatory securities valuation reserve) to that of the 48 of 50 top U.S. life insurers (excluding ELIC and one firm not licensed to do business in California). FCLIC was *not* the most likely candidate for seizure among this group, based either on unadjusted or on mark-to-market statutory net worth (net worth adjusted for market-wide losses on junk bonds, real estate, and mortgages). On the latter basis, FCLIC ranks eighth of 49 firms on April 30, 1991. On just one basis – statutory net worth adjusted *only* for market-wide junk bond losses at December 31, 1990, the year-end for statutory reporting – was

FCLIC a likely candidate for seizure; on this basis FCLIC had the lowest capital of all 49 insurers.

This finding suggests that regulators targeted insurers that specialized in junk bond investments in the political backlash against the 1980s. We estimate the value lost by FCH stockholders and creditors at $740 million to $1 billion. Section 2 describes key events at FCH that led to regulatory seizure of its subsidiaries. Section 3 analyzes daily surrender requests at FCLIC, which show a dramatic increase following California regulators' remarks that FCLIC required a substantial cash infusion to survive. Section 4 compares FCLIC's statutory capital – as reported and on a mark-to-market basis – to that of major life insurers with California policyholders. Section 5 explores factors that contributed to FCH's collapse. Section 6 discusses the implications of our findings for firms with controversial investment and financing policies.

2. First Capital holdings: Its rise and fall[1]

Like First Executive Corporation (FE), First Capital Holdings (FCH) was a Los Angeles-based insurer that grew explosively in the 1980s. Both firms sold annuities and interest-sensitive life insurance products through independent brokers and agents, were run by strong-willed CEOs (Fred Carr at FE, Robert Weingarten at FCH), and were able to offer customers attractive yields in part by investing a substantial portion of their firms' assets in junk bonds. In short, the two firms' nontraditional operating and investment strategies made them upstarts in the life insurance industry. In 1990, FCH had life insurance in force of $31 billion and total assets of $9.7 billion; junk bonds comprised 40.4% of its investments. FE had life insurance in force of $49 billion and total assets of $15 billion; 67.1% of its investments were in junk bonds. However, FCH had 60% more policyholders and annuitants – 593,000 versus 375,000 for FE, which specialized in marketing large policies to high-income individuals.

FCH was founded in 1983 by Robert Weingarten, a former financial publisher. Its rapid growth was fueled by acquisition of two major insurance subsidiaries: First Capital Life Insurance Company (FCLIC), monitored by California insurance regulators, and Fidelity Bankers Life Insurance Company (FBLIC), monitored by Virginia regulators. At year-end 1990, FCLIC had

[1] Sources for material presented in this section include forms 10-K, 10-Q, and proxy statements for First Capital Holdings Corporation and First Executive Corporation, *Wall Street Journal*, *New York Times*, and *Los Angeles Times* articles, *Moody's Bank & Finance Manual* for 1991, *Best's Insurance Reports – Life/Health* for 1991, and Cole (1992b), Feder (1992), Heins (1987), Kerwin (1991), Kerwin and Spiro (1991a), and St. George (1992).

$4 billion in assets (up from about $2 billion when acquired in May 1987), and FBLIC had another $4 billion (up from $194 million when acquired in November 1985). Previously, FCLIC had been owned by the E.F. Hutton Group (later itself acquired by Shearson Lehman Brothers). Hutton, later as Shearson, continued as FCLIC's major sales force after FCH acquired FCLIC, accounting for more than 75% of FCLIC's sales during 1986–1991 according to regulators (*Los Angeles Times*, May 8, 1991, D1).

In 1988, Shearson purchased 44% of FCH's common stock, including the 17% held by the Robert Weingarten family. Shearson's purchase included the right to designate four of six FCH directors. Although its stake later fell to 28% (when others converted preferred to common stock), Shearson designates constituted a majority of FCH's board through FCLIC's conservatorship. Shearson's stake in FCH – which linked Shearson's parent, American Express, to FCH's California subsidiary, FCLIC – later became a major factor in FCLIC's May 1991 regulatory seizure when John Garamendi, California's newly-elected Insurance Commissioner, failed to convince American Express to contribute additional capital to FCLIC.

Since both FCH and FE had invested heavily in junk bonds, both suffered asset value declines during the junk bond market turmoil that began in late 1989 and continued through 1990. In January 1990, FE announced a major writedown for junk bond losses; insurance ratings downgrades and adverse publicity followed, as did a run that forced FE to liquidate nearly $4 billion in assets (DeAngelo, DeAngelo, and Gilson, 1994; hereafter DDG). [Fenn and Cole (1994, Table 1) document that FE's writedown significantly depressed the stock prices of insurers with large junk bond holdings.] In April 1991, when ELIC was seized by California regulators, it held the largest junk bond portfolio (as a percent of investments) of any operating insurer. After ELIC's seizure, FCLIC held that title for just one month (*New York Times*, May 6, 1991, D1), until it too was seized.

2.1. Media coverage of First Capital and First Executive

DDG document that First Executive received extensive adverse media coverage during the junk bond market turmoil of 1989–1990, and argue that such coverage contributed to FE's collapse by undercutting policyholder confidence in the firm's financial products. In strong contrast, FCH received very little press coverage of its junk bond holdings or of any other aspect of the firm, indicating that media speculation played no major role in its later downfall. Thus the mix of factors underlying FCH's downfall differs from that underlying FE's collapse (analyzed in DDG), although the analysis presented below indicates that the political backlash against the 1980s played a role in both cases.

The Appendix details major events for FCH during 1990–1991, including our judgment of the relevant (for FCH) events at FE, ELIC, and in the junk bond

market. The chronology begins in January 1990 with events preceding FE's bank run and culminates with the May 1991 seizures of FCH's subsidiaries. Of the 25 entries before the first negative news about FCH (its March 15, 1991 announcement discussed below), only one focuses on FCH – the March 12, 1990 *Heard on the Street* column, which discusses FCH's junk bond defaults. (FCH receives brief mention in two other *Heard on the Street* columns that focus on possible writedowns at Shearson due to declines in the market values of its investments.)

With these exceptions, the first *Wall Street Journal* (*WSJ*) report of difficulties at FCH came on March 15, 1991 (carried in the March 18, 1991 *WSJ*) when FCH revealed that it was reducing its previously announced 1990 earnings by $34.8 million to $7.1 million because of problems with its junk bond portfolio, that CEO and founder Robert Weingarten had resigned, and that it was negotiating the sale of FCLIC's core universal life business. While FCH's stock price fell 16% at this announcement, the Appendix reveals limited financial press interest in the firm between March 18 and the events of early May 1991 (described below).

The difference in pre-seizure press coverage of FCH and FE is remarkable given the similarities in the two firms' operating and investment strategies. For FE, DDG find 47 adverse news items in the *WSJ* and 32 feature articles (in the *WSJ*, *Barron's*, the *Los Angeles Times*, and *New York Times*) from July 1989 to ELIC's April 1991 seizure. For FCH, we find only one adverse *WSJ* news item (the March 18, 1991 earnings reduction) and two feature articles in the latter four publications from July 1989 to May 6, 1991, when regulators aired their concerns about FCLIC.[2] First Executive CEO Fred Carr's colorful remarks about the desirability of junk bond investments, competitors' solvency, etc. likely made that firm a lightning rod for criticism (DDG, 1994, Section 2), while FCH management's low-profile strategy probably discouraged media interest in FCH.

2.2. The key events of May 1991

The situation changed radically on May 6, 1991 when the *WSJ*, the *New York Times*, and the *Los Angeles Times* reported that California Insurance Commissioner John Garamendi had flown to New York to convince American Express to 'prop up' FCLIC to 'head off a potential failure'. On May 7, all three papers

[2]The two feature articles are the March 12, 1990 *Heard on the Street* and the March 25, 1991 Allan Sloan column in the *Los Angeles Times*. The April 17 and December 28, 1990 *Heard on the Street* columns do not meet DDG's criteria for a feature article because FCH is not the focus. FCH's troubles also received passing mention in two *Barron's* articles (October 1, 1990 and February 11, 1991) and a *New York Times* feature on Drexel's failure (February 14, 1990).

said that Garamendi had made little progress in these talks, and Garamendi stated at a Senate Commerce Committee hearing and on national television that FCLIC needed a substantial cash infusion to survive. He also said, in the colorful fashion that is his trademark, that this infusion was American Express's problem: 'If membership has its privileges, then ownership has its responsibility.'

Garamendi and American Express could not agree whether American Express should provide financial guarantees to *all* FCLIC's customers (Garamendi's position) or only to those that were Shearson customers (American Express' position). As we document below, surrender requests at FCLIC increased dramatically when these discussions became public. Increased surrender activity prompted California regulators on May 10 to issue a cease and desist order that halted surrender payouts and prohibited FCLIC from writing new business.

On May 13, Virginia regulators placed FBLIC, FCH's other major subsidiary, in conservatorship. They stated that, although FBLIC was fundamentally sound, so many people were surrendering their policies in the wake of California regulators' actions against FCLIC that, without supervision, the transaction of further business could be 'hazardous' to policyholders. Also on May 13, FCH's senior lenders, led by Citibank, filed involuntary bankruptcy petitions against FCH in an attempt to protect their own positions in light of regulators' actions against FCH's main subsidiaries.

On May 14, California regulators placed FCLIC in conservatorship 'to protect the assets of First Capital Life and the savings and benefits of thousands of policyholders from being ensnared in Citibank's attempt to place First Capital Holdings in involuntary bankruptcy' (*New York Times*, May 15, 1991, D1). With its subsidiaries under regulatory control, FCH lost access to their cash flow since, as Garamendi put it, regulators had 'walled off' the insurance subsidiaries from the holding company. On May 15, FCH missed a $7.5 million debt payment. On May 21, FCH said it would file for Chapter 11, which it effectively did on May 30 by consenting to Citibank's earlier bankruptcy petition.

3. Surrender demand at FCLIC was driven by regulators' actions

Table 1 reports FCLIC's monthly cash disbursements for life and annuity surrenders from January 1989 through April 1991, the last full month before regulatory seizure. Each monthly figure is the amount *distributed* by FCLIC, as opposed to the amount *requested* by policyholders. Unless surrender demand is unusually high or low, FCLIC employees cite a delay of about a week (plus or minus a few days) to process surrender requests. Hence a change in surrender requests will show up with a lag in Table 1's monthly cash disbursements, which should therefore be interpreted as a rough measure of surrender demand at FCLIC.

Table 1
Monthly cash surrender disbursements ($ millions) for life insurance and annuities of First Capital Life Insurance Company (FCLIC): January 1989 through April 1991

The figures are the dollar amount *distributed* each month for life and annuity surrenders at FCLIC (as distinguished from the surrender payments *requested* by policyholders).

	1989	1990	1991
January	$30.1	$59.0	$85.4
February	41.1	78.1	86.4
March	56.7	97.6	90.7
April	52.5	95.8	109.0
May	50.4	73.1	Seizure
June	36.7	79.0	
July	26.3	48.3	
August	46.8	48.1	
September	88.1	48.4	
October	111.4	78.8	
November	203.8	91.7	
December	46.7	58.2	
Annual total	$790.6	$856.1	n/a

Table 1 shows no sign of a contagion-induced bank run at FCLIC from the major run that developed at FE in January 1990. Rather, surrender disbursements at FCLIC increased in September 1989 (well before FE's run and approximately when trouble began in the junk bond market) and continued, with some month-to-month variation, at an elevated level through April 1991. Although FCLIC's average monthly disbursements nearly doubled from $42.6 million in January–August 1989 to $83.8 million in September 1989–April 1991, no subperiod shows any indication of the large cash drain one would expect during a major run. In FE's run, for example, the firm distributed almost $3 billion in the first half of 1990, more than four times FE's payout in 1988, and ten times its payout in 1986 (per DDG).

While FE's troubles did not engender a dramatic increase in surrenders at FCLIC, the firm did experience a substantial decline in new business during 1990. For the parent company, premiums received fell from $2.7 billion in 1989 to $1.3 billion in 1990, a 52% decline. Consistent with a market-anticipated decline in new business, FCH's share price fell roughly 50% in January 1990. More generally, Fenn (1995) finds an association between FE's collapse and a decline in asset growth for insurers specializing in junk bond investments, which he interprets as evidence that junk bonds had become a 'stigmatized' asset class that policyholders sought to avoid by the early 1990s. We discuss the political ramifications for FCH of the junk bond controversy in Section 5 below.

Although the fall-off in new business was obviously not good news for FCH stockholders, it posed no immediate financial problems for the firm. In fact,

FCLIC's liquidity compares favorably to that of other insurers at year-end 1990, according to Townsend & Schupp (1991). FCLIC's $455 million in cash plus short-term investments placed it 17th of 129 firms for its 12.3% ratio of cash plus short-term investments to estimated demand liabilities (mean, 5.1%). FCLIC ranks 68th for its 72.8% ratio of liquid assets (cash plus short-term investments plus market value of public bonds and stocks) to estimated demand liabilities (mean, 67.3%). On this basis, FCLIC ranks above eight of the top ten insurers: Metropolitan (81st), Equitable (89th), Travelers (93rd), Northwestern (100th), Prudential (103rd), Aetna (112th), Connecticut General (122nd), and John Hancock (129th).

FCLIC's liquidity, moreover, was more than ample to meet surrender demand before regulators' actions in early May 1991, based on the Table 1 data and the Townsend & Schupp study. FCLIC held $2.7 billion in liquid assets against an estimated $3.7 billion of surrenderable liabilities at December 31, 1990 (per Townsend & Schupp). If monthly surrender payouts remained at the $83.8 million average for September 1989–April 1991 (Table 1), FCLIC's liquid assets would be sufficient to satisfy surrender demand for a full 32 months into the future.

With the help of the California Insurance Department, we obtained from FCLIC the actual number of daily life and annuity surrender *requests* from January 29, 1990 through May 31, 1991, data that enable us to assess with a high degree of precision how surrender demand responded to developments at FCLIC and FE.[3] Our statistical tests take June 15, 1990 through March 15, 1991 as the benchmark for 'normal' surrenders.[4] The number of surrender requests typically differs across days of the week due, for example, to weekend accumulation of mail. Thus we estimate separate means and standard deviations for each day of the week, using data from the benchmark period. We calculate abnormal surrenders as actual surrenders minus the benchmark mean for the relevant day (e.g., Monday), with a t-statistic analogous to that employed in event studies to estimate abnormal stock returns.

The t-statistics show no evidence of elevated surrender demand at FCLIC before ELIC's seizure, either during FE's bank run or after FE's run but before

[3]FCLIC began keeping daily records of surrender requests on January 22, 1990, immediately after FE's January 19 junk bond writedown announcement that triggered FE's run. FCLIC retained records of the total weekly (not day-by-day) surrender requests for the week ended January 26. Consistent with FCLIC's monthly data in Table 1, that week shows a mildly elevated number of surrender requests, but no sign of a major run.

[4]Because FCLIC did not compile daily surrender data before January 1990, we cannot estimate 'normal' activity using data before September 1989, when the general level of surrenders increased (per Table 1). Hence, we assess abnormal surrender activity relative to a comparatively quiet subperiod within a period of generally elevated surrenders.

ELIC's seizure. The t-statistic exceeds 2.0 for just two of the 108 business days from January 29–June 29, 1990 (by which time surrender demand at FE had clearly subsided). Only ten days scattered among the remaining 198 business days until ELIC's seizure have t-statistics above 2.0, indicating that FCLIC's surrender demand remained relatively 'normal' through ELIC's seizure. After ELIC's seizure, FCLIC's surrender demand increased, with ten of twelve t-statistics above 2.0 in the last two weeks of April 1991.

Table 2 groups the events described in the Appendix into three categories of negative disclosures about FE – poor financial performance, increased surrender activity, and increased regulatory oversight. For each category, the table presents test statistics to assess the significance of abnormal surrenders at FCLIC for both (i) the business day after and (ii) the five business days after a given event. Since some events are clustered within one or a few days, we remove the double counting that would occur if we simply averaged five days of abnormal surrenders for all events in a given category.

Table 2 shows that disclosures of increased regulatory oversight at FE are associated with elevated surrender requests at FCLIC, with test statistics of 2.03

Table 2
Abnormal surrender demand at First Capital Life Insurance Company (FCLIC) potentially generated by 'contagion' from negative news about First Executive Corporation (FE)

The table reports the mean abnormal number of annuity and life surrender requests at FCLIC for the business day after and for the five business days following various negative disclosures about FE. Abnormal surrender demand is measured as the actual number of surrender requests on a given day minus an estimate of the normal demand for that day of the week. We estimate the normal level of demand as the mean number of requests on a given day of the week (e.g., all Mondays) from 6/15/90 through 3/15/91. For the latter period, we also calculate the standard deviation of surrender requests for each day of the week, and the resultant figures are inputs to the t-statistics reported below, which are generated analogously to the test statistics employed in event studies to assess abnormal stock returns. Within a given category, the five-day surrender measure removes any double-counting that might arise had we simply added up the five-day surrender quantities for events clustered closely in time. The negative disclosures are described in more detail in the Appendix.

		Abnormal surrenders at FCLIC (t-statistic)	
	Number of events	On next day	Over next five days
Poor financial performance reported by FE	11	27.0 (0.01)	312.9 (1.48)
Additional surrender demand and/or 'bank run' at FE	6	− 28.5 (− 0.40)	178.7 (1.02)
Increased regulatory oversight of FE	10	209.7 (2.03)	1087.8 (4.06)

and 4.06 for the one-day and five-day periods. Table 2 also shows that FCLIC's surrender requests did not change materially in response to reports about FE's poor financial performance or increased surrender demand (t-statistics for one-day and five-day abnormal surrender requests range between -0.40 and 1.48). Overall, then, contagion from FE was modest, and was limited to news of adverse *regulatory* developments as opposed to other types of negative disclosures.

Table 3
Daily surrender requests immediately following California Insurance Commissioner Garamendi's attempt to convince American Express to contribute capital to First Capital Life Insurance Company (FCLIC).

The table presents the number of life and annuity surrender applications received by FCLIC on each of the five business days immediately following the first public report that California regulators were seeking a capital infusion for FCLIC from American Express. The abnormal number of surrenders is the actual number of requests received on that day minus the number normally received on that particular day of the week. The normal surrender level is estimated as the mean number of applications received on a given day (e.g., all Mondays) from 6/15/90 through 3/15/91. This period is used to estimate normal surrender activity since (i) it follows the bulk of the 1990 'bank run' at Executive Life and (ii) it precedes the regulatory seizure of Executive Life and the initiation of adverse news about FCLIC. The t-statistic is calculated from the abnormal surrender amount and the standard deviation of surrender requests (e.g., all Mondays during the same estimation period).

Date	News reported	Number of surrender requests received the next business day (Abnormal number)	t-statistic
5/6/91	Garamendi seeks capital infusion from American Express	586 (473)	10.33
5/7/91	Garamendi has made little progress in talks with American Express	1,240 (1,147)	29.74
5/8/91	Garamendi states FCLIC needs a 'substantial infusion of cash to survive'	1,773 (1,693)	71.29
5/9/91	Recent news has prompted many FCLIC customers to cash in their policies	2,227 (2,131)	70.86
5/10/91	California regulators are expected to sharply curtail FCLIC operations and ultimately to place the firm in conservatorship	1,190 (1,060)	32.12
5/13/91	Garamendi issues a cease and desist order forcing FCLIC to stop writing new business and to stop redeeming existing policies and annuities	n/a	n/a
Total surrender requests over the week following disclosure that California regulators were seeking a capital infusion for FCLIC		7,016 (6,504)	95.86

FCLIC's surrender demand increased dramatically following news reports in early May 1991 that California regulators had asked American Express for a capital infusion. Table 3 focuses on surrender activity at FCLIC in the five business days after the initial news reports of these discussions. Over the two days following the May 6 and 7 reports that Garamendi was seeking but had not yet obtained a capital infusion, the number of surrender requests at FCLIC exceeded normal by 473 and 1,147, with associated t-statistics of 10.33 and 29.74.

Surrender demand escalated further after the May 8 news that Garamendi believed FCLIC needed a substantial cash infusion to survive. Over the next three business days, surrender requests exceeded normal by 1,693, 2,131, and 1,060, with respective t-statistics of 71.29, 70.86, and 32.12. Over the five days covered in Table 3, abnormal surrender requests totaled 6,504 with a remarkably large t-statistic of 95.86. In these five days FCLIC received 7,016 surrender requests, more than three times the average *monthly* surrenders of 2,210 (median 2,252) from March 1990 through April 1991. The number of surrender requests continued to be substantial after the May 13 report that California regulators had ordered FCLIC to stop honoring such requests (data not reported in Table 3).

Commissioner Garamendi has disclaimed responsibility for FCLIC's run, saying that the 'wave of surrenders commenced well before I made my public comments about the company' (Garamendi, 1992; St. George, 1992).[5] While surrender requests did increase before Garamendi's remarks – just a few weeks before, following his April 11 seizure of ELIC – FCLIC's mid-April surrender increase was dwarfed by the vastly larger increase in May following Garamendi's remarks. In the week before the Garamendi–American Express talks were disclosed, FCLIC's abnormal surrender requests totaled 605, an average of 121 per business day. In the week immediately after that disclosure, FCLIC's abnormal surrender requests totaled 6,504, more than ten times the prior amount (to an average of 1,301 per day).[6]

[5]In an earlier article ('Garamendi's Political Fate Linked to Activist Stance', *Los Angeles Times*, May 16, 1991, A1), 'Garamendi concedes that the run on First Capital...accelerated after word leaked out that the commissioner was on Wall Street trying to put together a bailout plan.' In the article, Garamendi defends his actions by saying that the only way to guarantee confidentiality is to do nothing, and doing nothing is what his predecessor, Roxani Gillespie, did in the ELIC case, thereby allegedly causing material losses for policyholders.

[6]The same picture emerges when we examine FCLIC's surrender requests over the three weeks between ELIC's seizure and disclosure of regulators' concerns about FCLIC. During this three-week period, FCLIC's abnormal surrenders totalled 1,444, an average of 103 per business day, versus an average of 1,301 per business day for the week following disclosure of regulators' concerns.

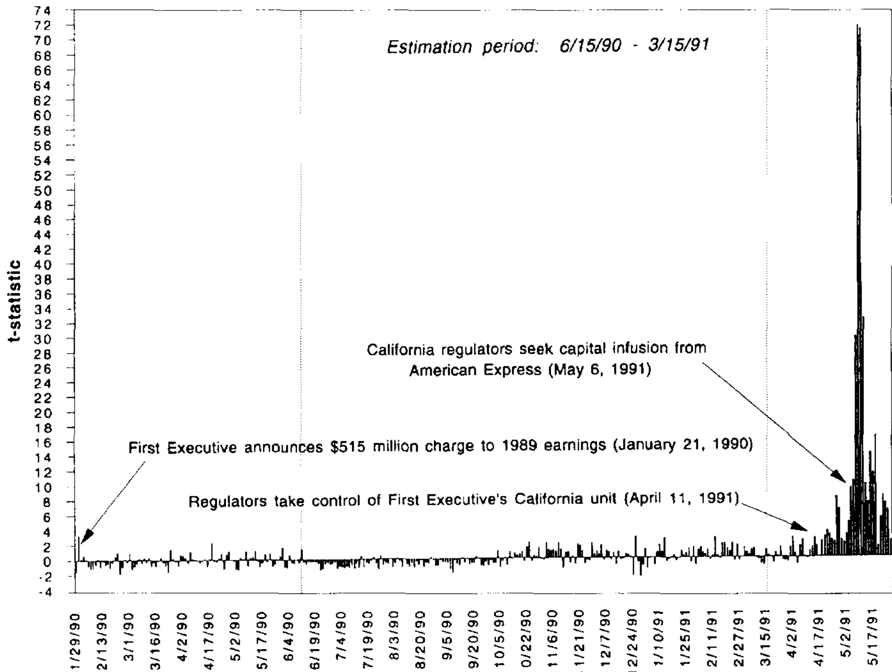

Fig. 1. Daily surrender requests received by First Capital Life Insurance Company (FCLIC) beginning with First Executive's bank run and ending two weeks after regulatory seizure of FCLIC.

The figure reports t-statistics to assess the significance of the abnormal annuity and life surrender requests received each day in FCLIC's mailroom. [Since even express mail deliveries take a day, these surrender data will reflect a small lag from the events that triggered policyholders' redemption decisions.] The reporting period begins on 1/29/90, the first day that FCLIC surrender data are available after First Executive's 1/21/90 writedown announcement that triggered its run. The last day of FCLIC surrenders shown here is 5/28/91, which is two weeks after California regulators seized FCLIC. Abnormal surrender demand on a given day is measured as the number of surrender requests on that day minus an estimate of the normal demand for that day of the week. We estimate the normal level of demand as the mean number of requests on a given day of the week (e.g., all Mondays) from 6/15/90 through 3/15/91. For the latter period, we also calculate the standard deviation of surrender requests for each weekday, and the resultant figures are inputs to the t-statistics, which are generated analogously to the test statistics employed in event studies to assess abnormal stock returns.

Fig. 1 illustrates the dramatic surrender increase that followed regulators' remarks, showing that FCLIC's daily surrender t-statistics skyrocketed in early May, and that they exceed by far the t-statistics we observe for FCLIC's surrenders in earlier periods (including FE's bank run in early 1990 and ELIC's seizure-related events in April 1991). These data establish that FCLIC's surrender demand increased materially when it became public knowledge that Garamendi was seeking, but had not obtained, a capital infusion, with surrender

requests peaking in the two days after he questioned FCLIC's ability to survive given its current resources.[7]

Had surrender requests continued at the massively increased rate of early May 1991, FCLIC's ability to survive without a capital infusion was indeed questionable. We estimate that had surrender requests continued for all of May at the May 1–May 13 rate, FCLIC would have had to disburse some $676.7 million to meet May's surrender demand.[8] This amount is more than eight times the $83.8 million average monthly surrender disbursement from September 1989–April 1991. If surrender requests had persisted at early May's elevated level, they would have exhausted FCLIC's $2.7 billion in liquid assets in less than four months.

In short, daily surrender data show that FCLIC experienced a survival-threatening run when California regulators' comments created a public perception that the firm was seriously troubled. Regulators then attempted to deal with the run without seizing FCLIC by issuing a cease and desist order that prohibited further surrender payouts. This strategy proved unsuccessful because FCH's senior lenders responded by filing to place FCLIC's parent in bankruptcy, which in turn led regulators to seize FCLIC. Thus, circular as it seems, regulators felt compelled to seize FCLIC when their control of the situation was threatened by other parties' responses to circumstances that regulators themselves had precipitated.

4. Did FCLIC's financial condition justify regulators' actions?

To evaluate California regulators' actions, we compare FCLIC's statutory net worth (capital plus mandatory securities valuation reserve) to that of other life insurers with California policyholders. The mandatory securities valuation reserve (MSVR) is a statutory liability that provides a cushion against fluctuations in the values of securities held. Life insurance analysts typically add MSVR to statutory capital, since valuation losses recognized on securities held reduce MSVR rather than statutory capital.

---

[7]One might argue that California regulators were not responsible for the run at FCLIC if they were not the (unnamed) source of the initial press report that Garamendi was seeking a capital infusion. However, even if regulators were not the source, Garamendi's remarks the next day in the Senate and on national television inflamed rather than calmed policyholders. Thus it is difficult to absolve regulators of responsibility for FCLIC's run.

[8]FCLIC received 8,010 surrender requests in the nine business days from May 1–May 13. Given 22 business days in a month, the estimated surrender demand for May is $8{,}010 \times 22/9 = 19{,}580$ requests. The median dollar request, based on surrenders from March 1990–April 1991, is $34,562. May's estimated cash disbursement is therefore $\$34{,}562 \times 19{,}580$ requests = $676.7 million.

We focus on FCLIC rather than on FCH because California regulators were charged with monitoring the financial condition of the insurance subsidiary and not the parent firm. We use statutory net worth because regulators use statutory data to assess solvency. We also employ mark-to-market statutory net worth to incorporate asset value declines that are not reflected in statutory figures, although this approach has some limitations (see DDG, 1994, Section 6.3). We do not focus on the stock market's valuation because (1) only the parent is publicly traded and (2) stock prices will incorporate the expected costs of regulatory intervention, hence do not measure financial condition absent regulatory action.[9]

If regulators' decision to single out FCLIC was justified, the firm's statutory net worth should be the lowest among (or at least materially below average for) other life insurers with California policyholders. Our analysis indicates that FCLIC ranks lowest only if one (i) assigns a material additional discount to junk bonds (above that dictated by the National Association of Insurance Commissioners), (ii) ignores the generally greater contemporaneous declines in market values for real estate/mortgages (DDG, 1994, Fig. 3), and (iii) ignores the 13–21% returns in the junk bond, real estate, and mortgage markets from year-end 1990 to FCLIC's May 1991 seizure. When we mark *both* junk bonds and real estate/mortgages to market, FCLIC's net worth is far from lowest. Since FCLIC has the lowest net worth only with a differential discount for junk bonds, it seems likely that these investments made the firm a regulatory target.

As a comparison sample for this analysis, we start with the 50 top U.S. life insurers (from the June 3, 1991 *Fortune* 'Service 500'), from which we delete ELIC, which was no longer operating independently in May 1991, and the one firm not licensed to do business in California. This 48-firm comparison sample includes many but not all life insurers whose financial health would be of concern to California policyholders. (In early 1991, the California Department of Insurance had regulatory oversight for more than 50 insurers domiciled in

[9]At year-end 1990, FCH's stock market value was $76 million or 0.8% of total assets – a low figure that probably reflects the firm's decline in premium revenue (see Section 3) and the likelihood of regulatory intervention, both at its subsidiaries and in the junk bond market (see Section 5). FCH's low stock market valuation does not differentiate it from the other three publicly traded holding companies with large life insurance subsidiaries domiciled in California (total assets over $1 billion, see Footnotes 10 and 12 for details). In fact, two of the three holding companies were in very similar positions at year-end 1990: Conseco had an equity market value of $149 million and an equity-to-assets ratio of 1.8%, while Broad Inc. had an equity market value of $176 million and an equity-to-assets ratio of 1.7%. Both these holding companies had very thin equity cushions as measured by stock market valuations, similar to FCH, yet neither was publicly targeted by California regulators for its poor financial condition. The difference in equity valuations could plausibly be driven by higher expected costs of regulatory intervention at FCH due to its controversial investment policy.

California and another 640 insurers licensed to do business in the state.[10]) Our approach may be biased toward finding FCLIC in worse financial condition than the other 48 insurers, because they are larger firms whose statutory net worth ratios are likely greater due to 'surplus stacking' of insurance subsidiaries.[11]

For each of the 48 insurers and FCLIC, we use the *A.M. Best* summary of the year-end 1990 statutory filings to determine the ratio of net worth to total assets (excluding separate accounts), and investments in junk bonds, real estate, and mortgages. Statutory statements carry junk bonds in default at market value, but do not mark down the other assets. Since we do not have information on each firm's portfolio performance, we estimate mark-to-market net worth using (i) Merrill Lynch's and Salomon Brothers' indexes to adjust for average market performance of junk bonds and (ii) stock market-based indexes from the National Association of REITs and Wilshire Associates to adjust for changes in the market values of mortgages and real estate. (See DDG for details on these indexes and the limitations of using assets' market values to assess insurer solvency.)

In the analysis below, we mark assets to market using index rates of return beginning in July 1989 (just before turmoil began in the junk bond market) through December 1990. This interval captures essentially all the deterioration in junk bond values, but omits a significant portion of the decline in mortgage values which began somewhat earlier (see DDG, 1994, Fig. 3). Thus, following the procedure elaborated by DDG, we impute a 9.2% decline in junk bond values over July 1989–December 1990 and contemporaneous leverage-adjusted declines of 27.0% and 23.8% in mortgage and real estate values. Our conclusions are unchanged when we use market index rates of return over January 1989 through December 1990 or over January through December 1990 (details not reported here).

[10]We generated a second comparison sample from the list of 57 California-domiciled life insurers in *Best's Insurance Report – Life/Health* for 1991. We dropped 21 firms without active individual life insurance or annuity operations in 1990 and eight firms with no *Best's* report. After we exclude FCLIC and ELIC, five of the remaining 26 firms have over $1 billion in assets, excluding separate accounts. (The other 21 firms have median assets of $145 million, versus $4 billion for FCLIC.) Of these five firms, three are among the top-50 insurers. If we treat the five firms as a second comparison sample, the results are similar to those reported in Tables 4 and 5 (details in Footnote 12).

[11]'Surplus stacking' occurs because statutory accounting uses the equity method to account for investments in subsidiaries, thereby adding subsidiaries' capital to that of the parent. At year-end 1990, FCLIC had $4.1 billion in total assets, versus $10.5 billion for the median top-50 life insurer (and $4.9 billion for the firm ranked fiftieth). The larger size of the insurers in our comparison sample suggests that they were more likely than FCLIC to have downstream subsidiaries, thus greater statutory net worth ratios for that reason alone.

Table 4 reports year-end 1990 statutory net worth ratios for FCLIC and the other 48 insurers for nine valuation scenarios ranging from no mark-to-market adjustment (northwest corner) to full mark-to-market adjustment using the index returns described above (southeast corner). Each cell displays five

Table 4
Adjusted statutory net worth at year-end 1990 of First Capital Life Insurance Company (FCLIC) and the 48 largest U.S. insurers licensed to do business in California

The comparison group of 48 firms is *Fortune's* (June 3, 1991) list of the 50 largest life insurers, minus Executive Life (seized by regulators in April 1991) and one firm that did not do business in California. The statutory net worth ratio is capital plus mandatory securities valuation reserve, divided by total assets (per *Best's*). Using a methodology described in detail in the text, we adjust each firm's net worth ratio for estimated changes in the market values of junk bonds not in default, mortgages, and real estate. (Bonds in default are already marked to market in statutory filings.) The table presents nine valuation scenarios ranging from no mark to market for any asset class (northwest corner) to full mark to market for junk bonds, real estate, and mortgages (southeast corner). The estimates reported here are based on market indexes for junk bonds, real estate, and mortgages for July 1989 (just before the junk bond market turmoil began) through December 1990. We obtain the same qualitative picture with index returns measured over (i) January 1989 through December 1990 and (ii) January through December 1990.

Junk bond adjustment	Mortgage and real estate adjustment		
	None	Half	Full
None	4.50%	3.62%	2.54%
	5.60%	3.36%	0.41%
	6.59%	3.84%	0.73%
	− 0.61	− 0.05	0.31
	39	22	17
Half	2.79%	1.88%	0.76%
	5.39%	2.96%	0.12%
	6.32%	3.56%	0.43%
	− 1.01	− 0.39	0.06
	49	31	23
Full	1.01%	0.07%	− 1.09%
	5.23%	2.55%	− 0.23%
	6.06%	3.28%	0.13%
	− 1.40	− 0.74	− 0.21
	49	40	28

Data in each cell:
(1) FCLIC's net worth as a percent of total assets (NW/TA).
(2) Median of comparison firms' NW/TA.
(3) Mean of comparison firms' NW/TA.
(4) t-statistic for difference in FCLIC and comparison firm mean NW/TA.
(5) FCLIC's NW/TA rank within group (1 = highest, 49 = lowest).

statistics for a particular valuation scenario: (1) FCLIC's statutory net worth as a percent of total assets (NW/TA), (2) the median of comparison firms' NW/TA, (3) the mean of comparison firms' NW/TA, (4) the t-statistic for a test of the difference between FCLIC's NW/TA ratio and that of the comparison group mean, and (5) FCLIC's NW/TA rank, where one is the highest and 49 the lowest possible rank.

The northwest corner of Table 4 indicates that FCLIC's 4.50% unadjusted statutory net worth ratio was close to, but below both the median 5.60% ratio and the mean 6.59% ratio for the other 48 life insurers. However, the difference between FCLIC's unadjusted net worth ratio and that of the mean comparison firm is not statistically significant (t-statistic $= -0.61$). Based on its unadjusted statutory net worth ratio, FCLIC ranks 39th of 49 firms – a relatively poor showing, but one that does not flag the firm as the most obvious problem case among insurers with California policyholders, since ten firms ranked even lower.

The southwest corner of Table 4 shows that, if we adjust *only* for the market-wide decline in junk bonds and ignore declines in mortgages and real estate values, FCLIC falls to worst (49th) among the comparison sample. This finding holds whether we adjust for half or all the market-wide decline in junk bonds, although in both cases FCLIC's ratio is not statistically different from the comparison sample mean (respective t-statistics of -1.01 and -1.40). In both cases FCLIC's adjusted statutory net worth ratio is positive, with respective values of 2.79% and 1.01%, indicating that the firm was not insolvent at year-end 1990, considering only the market decline in junk bonds through that time.

Finally, the southeast corner of Table 4 reports statutory net worth adjusted for both the decline in junk bonds and for the contemporaneous decline in real estate and mortgages. With the full market adjustment for junk bonds, real estate, and mortgages, FCLIC ranks close to the middle of the pack – 28th out of 49 firms. Although FCLIC now has a negative net worth ratio, so does the median comparison firm, and there is no statistical difference between FCLIC's net worth ratio and that for the mean firm (t-statistic $= -0.21$). Since these data indicate that many major life insurers had financial difficulties at least as serious as FCLIC's at year-end 1990, they suggest that regulators were not warranted in singling out FCLIC for its poor financial condition.[12]

---

[12]Among the six California-domiciled life insurers with assets greater than $1 billion (see Footnote 10 for selection details), FCLIC ranks last at year-end 1990 if only junk bonds are marked-to-market, and fifth with full mark-to-market adjustment for junk bonds, real estate, and mortgages. Among the same comparison group at April 30, 1991, FCLIC ranks first of six if junk bonds alone are marked-to-market, and second with full mark-to-market adjustment for junk bonds, real estate, and mortgages.

4.1. Junk bond, mortgage, and real estate appreciation in early 1991

The case for regulators' actions against FCLIC in May 1991 is even weaker when we adjust for the large increase in early 1991 in the market values of junk bonds, mortgages, and real estate. The data underlying DDG's Fig. 3 indicate that these asset classes appreciated by 21.0%, 12.6%, and 16.6%, respectively, from January through April 1991 (before regulators' concerns about FCLIC became public in early May 1991). Accordingly, Table 5 reports statutory net worth statistics at April 30, 1991 by bringing the figures underlying Table 4 forward in time using the index rates of return over January through April 1991.

The southwest corner of Table 5 indicates that, adjusted only for junk bond market returns, FCLIC's net worth ratio rises *above* both the mean and median ratios for the comparison firms. The southeast corner shows that, with full adjustment for junk bond, real estate, and mortgage market returns, FCLIC's ratio again exceeds both the mean and median of the comparison sample. Not only is FCLIC's net worth ratio positive by a comfortable margin in both cases, it actually ranks near the *top* of the comparison sample – eighth of 49 firms with full market adjustment of all asset classes (southeast corner of the table). Even more than the Table 4 results, these findings cast doubt on regulators' decision to single out FCLIC as a firm in financially precarious condition in early May 1991.

It is especially difficult to understand the May 1991 timing of California regulators' public statements questioning FCLIC's health, given that junk bond, mortgage, and real estate market values increased substantially in early 1991.[13] Considering the recent improvement in FCLIC's financial condition, it would seem reasonable to wait a bit longer to see if further improvements would materialize. [With hindsight, we know that the 21% returns in early 1991 were about one-third the eventual appreciation of around 60% in junk bond values (DDG, 1994, Fig. 3).] The substantial increases in asset market values would seem to indicate that early 1991 was a time for regulatory forbearance, rather than a time to make public remarks that cast doubt on FCLIC's ability to survive.

4.2. Regulatory dispute over surplus relief reinsurance

In addition to its junk bonds, another factor influencing FCLIC's seizure was regulators' concern that FCLIC's statutory net worth inappropriately included

[13] Regulators were apparently not fully aware of the condition of the junk bond market at FCLIC's May 1991 seizure, since the application for order of conservatorship states: 'Also of major concern to the examiners is the fact that, as of December 31, 1990, a substantial portion of First Capital's bond portfolio consisted of high yield securities or 'junk bonds', *and the market for these securities is continuing to deteriorate*' (Superior Court of the State of California for the county of Los Angeles, 1991, p. 31, emphasis added).

Table 5
Adjusted statutory net worth at April 30, 1991 of First Capital Life Insurance Company (FCLIC) and the 48 largest U.S. insurers licensed to do business in California

The comparison group of 48 firms is *Fortune's* (June 3, 1991) list of the 50 largest life insurers, minus Executive Life (seized by regulators in April 1991) and one firm that did not do business in California. The statutory net worth ratio is capital plus mandatory securities valuation reserve, divided by total assets (per *Best's*). Using a methodology described in detail in the text, we adjust each firm's net worth ratio for estimated changes in the market values of junk bonds not in default, mortgages, and real estate. (Bonds in default are already marked to market in statutory filings.) The table presents nine valuation scenarios ranging from no mark to market for any asset class (northwest corner) to full mark to market for junk bonds, real estate, and mortgages (southeast corner). The estimates reported here are based on market indexes for junk bonds, real estate, and mortgages for July 1989 (just before the junk bond market turmoil began) through the end of April 1991 (immediately before regulators' public statements of concern about FCLIC's financial health). We obtain the same qualitative picture with index returns beginning January 1989 or January 1990.

Junk bond adjustment	Mortgage and real estate adjustment		
	None	Half	Full
None	4.50%	4.11%	3.39%
	5.60%	4.03%	2.85%
	6.59%	5.13%	3.10%
	− 0.61	− 0.27	0.06
	39	24	19
Half	6.60%	6.22%	5.54%
	5.92%	4.45%	3.03%
	6.92%	5.47%	3.46%
	− 0.09	0.20	0.45
	20	12	10
Full	8.29%	7.92%	7.26%
	6.25%	4.68%	3.35%
	7.19%	5.75%	3.75%
	0.33	0.58	0.77
	10	8	8

Data in each cell:
(1) FCLIC's net worth as a percent of total assets (NW/TA).
(2) Median of comparison firms' NW/TA.
(3) Mean of comparison firms' NW/TA.
(4) t-statistic for difference in FCLIC and comparison firm mean NW/TA.
(5) FCLIC's NW/TA rank within group (1 = highest, 49 = lowest).

$65.2 million (unamortized balance) in surplus relief reinsurance that appeared to, but did not actually, transfer risk to others.[14] The firm disagreed with regulators' concerns and stated that it believed it had

> '... valid defenses to the surplus relief issue including: (1) the reinsurance treaty forms had been previously allowed on examination for other insurance companies domiciled in California; (2) First Capital Life had submitted the treaty forms to the Insurance Department prior to entering into such contracts and had incorporated certain changes in language at the request of the Insurance Department; and (3) upon entering into the transactions, the executed treaties were submitted to the Insurance Department which did not object to their use.' (FCH's 10-Q, March 31, 1991)

Although FCLIC's reinsurance was much debated by regulators and FCH (see Feder, 1992), its magnitude is not sufficiently large to alter our conclusions. We re-ran the analyses in Tables 4 and 5, reducing FCLIC's net worth by the contested amount of $43.0 million ($65.2 million, net of income taxes at the 34% marginal rate). The resultant declines in FCLIC's net worth ratio and rank are not large, and the overall picture in Tables 4 and 5 is essentially unchanged. For the scenario in the southeast corner of Table 5, FCLIC's net worth ratio falls to 4.87% and its rank declines to 14th out of 49. Thus, even with complete disallowance of FCLIC's surplus relief reinsurance, our analysis indicates that FCLIC was not a firm in especially poor financial condition.

4.3. Economic impact of junk bonds in default

We also investigated the possibility that defaults in FCLIC's junk bond portfolio posed a serious immediate threat to the firm's financial health. However, at year-end 1990, a comparatively modest 6.3% (par value) of FCLIC's junk bonds were in default. [Altman (1991) documents that, for the junk bond market as a whole, 8.7% of par value defaulted or was exchanged under distressed conditions during 1990.] FCLIC had $8.3 million in accrued but unpaid interest due on junk bonds in default which, when annualized, represents lost income of about $18 million per year. This loss is a trivial fraction of FCLIC's $405 million in annual investment income (and of the firm's $455 million in cash plus short term investments). These figures indicate that junk

---

[14]Surplus relief reinsurance has been used by insurers to increase statutory capital since the early 1980s and apparently was widespread in the life insurance industry in early 1991; for example, Equitable relied on surplus relief insurance for $600 million, or more than one-third its statutory capital ('Insurance Regulators Mounting Attack on Controversial Financial Technique', *WSJ*, June 7, 1991, A4).

bond defaults did not pose a serious risk of cash flow insolvency to FCLIC at year-end 1990.

4.4. Regulatory forbearance

Our analysis suggests that regulatory forbearance would have been more appropriate than seizure in FCLIC's case. Such forbearance is apparently common (see, e.g., Kryzanowski and Roberts, 1993; James, 1991). According to one newspaper: 'In the past, when insurers got into trouble, the problems were typically solved in private. Money was raised; businesses were sold; the public was never the wiser. There was never a serious run on an insurer and no one has ever lost any of their principal on a life insurance policy' (*Los Angeles Times*, May 16, 1991, A1). ELIC was arguably insolvent at year-end 1989, yet regulators did not seize the firm until April 1991. So why was FCLIC singled out for attention when it was in not only relatively good but improving financial condition? More generally, what factors contributed to FCH's sudden and spectacular collapse?

5. FCH's collapse: Contributing factors

We consider evidence on several factors that contributed to the collapse of FCH: a political and regulatory climate that was hostile to junk bonds, recent turmoil in the junk bond market, the observability of junk bond losses, the incentives of the newly elected Insurance Commissioner in California to take an activist stance against the insurance industry, the existence of a parent firm with 'deep pockets', and corporate governance problems at FCH.

5.1. Political/regulatory climate hostile to junk bonds

At the time that ELIC and FCLIC were seized, the political/regulatory climate was hostile to junk bonds (see, e.g., Jensen, 1991 and 1993). In 1986, the Federal Reserve restricted the use of junk bond financing for takeovers. In 1987, the New York Insurance Department limited junk bond holdings to 20% of assets for insurers domiciled or licensed to do business in New York. In 1989, the Federal Reserve, the FDIC, and the Comptroller of the Currency restricted 'highly-levered' transactions, and the Federal Institutions Reform, Recovery, and Enforcement Act (FIRREA) was signed into law. FIRREA forced thrifts to sell all junk bond investments within five years, and in the interim to mark them to market, thereby immediately reducing regulatory capital by any market value declines on these bonds.

In 1990, the National Association of Insurance Commissioners (NAIC) both increased mandatory reserves for junk bond losses, and adopted more stringent

classifications of junk bonds for statutory filings. The motivation was 'to prevent companies from concentrating their investments in these bonds' (*New York Times*, May 11, 1990, D1). While the new rules increased the already positive mandatory reserves for junk bond losses, they simultaneously preserved for at least the next two years the zero reserve requirement for losses on mortgages and real estate. These differential reserve requirements penalized insurers that held relatively liquid assets, such as FCLIC, by increasing the amount of statutory capital necessary to support a given level of investment.

The new NAIC rules became effective for year-end 1990 statutory filings, and the broadened definition of high-yield debt forced insurers to report larger junk bond holdings during the height of the junk bond market turmoil. For FCH, the NAIC rule change caused reported junk bond holdings to more than *double*, from 20.2% to 40.7% of investments. This increase helped create a perception that FCH had recklessly loaded up on junk bonds before the market 'collapsed'. For example, according to the *Los Angeles Times* (May 11, 1991, A1):

> 'The company's portfolio of junk bonds, the high-risk, high-yield securities that financed the 1980s takeover boom, rose to be 46% of its assets today, from 16% in 1986, Garamendi said. The market for junk bonds crashed last year and the company said in a recent financial report that these assets are now worth $500 million less than the company paid for them.'

Although the article neglected to mention the fact, most of the reported increase was due to the NAIC accounting rule change.

5.2. Junk bond market turmoil and observability of junk bond losses

The junk bond market turmoil, which began in mid-1989 and continued through 1990, reflected a number of highly visible defaults, Drexel's problems and eventual bankruptcy, and the increased regulation discussed earlier. This turmoil, combined with a torrent of adverse publicity, sensitized the public to the risks of junk bonds. Market values are more observable for junk bonds than for less-liquid assets like real estate and mortgages. Because they specialized in junk bonds and had large surrenderable liabilities, FCLIC and ELIC were vulnerable to runs due to (readily observable) declines in junk bond market values.

5.3. ELIC's seizure and perceived similarities between FCH/FCLIC and FE/ELIC

ELIC was seized on April 11, 1991 in a flurry of publicity about its junk bond woes, the largest U.S. insurer ever to fail. Both ELIC's parent, FE, and FCH were Los Angeles-based insurance holding companies with two major subsidiaries, were Drexel clients with large junk bond holdings, were upstarts with large

annuity businesses in the mostly-staid insurance industry, and had 'First' in their titles. Given these surface similarities, it would be surprising if FCH's customers were *not* concerned about FCH's financial condition in the wake of ELIC's seizure. (Our Table 2 shows a significant increase in surrender requests at FCLIC after news of regulatory actions against ELIC.)

5.4. Newly elected Insurance Commissioner with political ambitions

John Garamendi was California's first elected Insurance Commissioner. A former state senator with no prior insurance experience, Garamendi campaigned to 'rein in the insurance industry' by active enforcement of the Proposition 103 rollback of automobile insurance rates.[15] His first act when he took office in January 1991 was to repeal the Proposition 103 regulations of his predecessor to 'turbo-charge' the process for getting rollbacks into consumers' hands. The new commissioner warned insurers that he meant business, and that his administration intended a return to the 'hard hand of regulation' rather than the 'don't worry, be happy' approach of his predecessor (*WSJ*, May 17, 1991, B1).

Given ELIC's well-publicized junk bond problems (see DDG, 1994), the new Insurance Commissioner had strong incentives to take immediate action against the firm. Such action was consistent with his promise of tough regulation and would likely be popular with voters, given the extensive adverse publicity. Moreover, ELIC was sufficiently troubled that, absent regulatory intervention, it might conceivably fail and embarrass the new administration. If Garamendi took quick and decisive action, he could blame ELIC's problems on lax regulation under his predecessor, which is exactly what he did (see, e.g., 'Insurance Chief Achieves Fame Amid Failures', *WSJ*, May 17, 1991, B1).

Within three months of taking office, Garamendi seized ELIC, citing the firm's junk bond problems and railing against the greed of the 1980s. At ELIC's seizure, he said: 'The fallout from the junk bond era continues to rain on innocent American investors. One casualty is the Executive Life Insurance Company' (*WSJ*, April 12, 1991, A1). Once Garamendi saw the flurry of positive press that followed ELIC's seizure, FCLIC's fate may have been sealed. If he seized FCLIC as well, Garamendi would be acting against the operating insurer with the largest percent of junk bond investments in the country. Seizure would enhance Garamendi's image as a tough regulator and would also eliminate any risk that FCLIC might fail on its own and embarrass his administration.

---

[15]Garamendi, the front-runner during the entire campaign, was on record as anti-junk bonds, promising to limit insurers' holdings (*Los Angeles Times*, May 25, 1990, A3). Consistent with our Section 4 discussion of FCH's 1990 stock price decline, the stock market could have forecasted increased scrutiny by California insurance regulators since at least early 1990.

Unlike ELIC, FCLIC had a corporate parent that the public perceived as financially strong. If Garamendi could convince American Express to contribute additional capital and thereby avoid seizing FCLIC, he could achieve all the above objectives at lower cost. In either case, he had a brief window after ELIC's seizure in which to take action against FCLIC, generate more positive press for his activist stance on junk bonds, and blame FCLIC's problems on his predecessor's failures. Consistent with the view that Garamendi was a savvy politician who would use the ELIC and FCLIC seizures to his political advantage, he framed the issues underlying the seizures in terms of 'the small investor – the hard hats and secretaries – against those who profited during the 1980s from an ethic of greed' (*Los Angeles Times*, May 16, 1991, A1).

The sheer size of these unprecedented regulatory seizures (together FE and FCH had nearly one million customers) was attention-grabbing. This, and the commissioner's colorful remarks, made him arguably California's most visible politician in early 1991. The publicity was valuable to Garamendi because of his well-known ambition for higher office; he did in fact run for governor in 1994 and is rumored to harbor ambitions for the presidency. Garamendi, moreover, could reasonably have expected his new job as Insurance Commissioner to serve as a useful platform from which to seek higher office, since the prior commissioner had received a respectable amount of publicity.

Table 6 catalogues the citations to Garamendi and his predecessor, Roxani Gillespie, in seven California and national newspapers and major periodicals during 1988–1992. These data show a large increase in Garamendi's citations during his 1990 campaign, when his total count tripled to 384 from 138 in 1989. In 1991, when he seized ELIC and FCLIC, the total nearly tripled again, to 1,000 mentions. Garamendi's periodical coverage soared from 20 mentions in 1990 to 250 in 1991; his citations in national newspapers jumped from six in 1990 to 160 in 1991. Roxani Gillespie's citations as commissioner were also substantial – totals of 183 in 1988 and 549 in 1989 – before Garamendi ran for the office.

FCLIC's capital was the lowest among major insurers with California policyholders only if junk bonds alone are marked to market at year-end 1990 (Section 4). Accepting this weak capital position as consistent with regulators' perceptions,[16] we still find it difficult to understand why they would express their concerns publicly, given the potential for a run (even if the Garamendi–American Express talks had been leaked by others). NAIC guidelines support

[16] California regulators indicate that they had held a number of discussions with FCH management about the adequacy of FCLIC's statutory capital, and that these discussions predate the arrival of John Garamendi. Regulators' ongoing concerns that FCLIC was undercapitalized, which go back to its E.F. Hutton days, probably also influenced regulators' actions against the firm in May 1991.

Table 6
Number of articles referencing John Garamendi and Roxani Gillespie in seven (California and national) newspapers and in selected major periodicals during 1988 to 1992

The table documents the number of newspaper and magazine articles referencing (i) John Garamendi, who took office in January 1991 as California's first elected Insurance Commissioner, and (ii) Roxani Gillespie, who preceded Garamendi as Insurance Commissioner. The cells with boldfaced numbers contain each individual's time as Insurance Commissioner. The count of references is based on a key word (headlines and text) search of the Dialog Information Service Databases, Dow Jones News Retrieval, and Nexis. The California newspapers are the *Los Angeles Times*, *San Francisco Chronicle*, and *Sacramento Bee*. The other newspapers are the *Wall Street Journal*, *New York Times*, *Washington Post*, and *Barron's*. The magazine search includes thousands of sources, including general business periodicals such as *Business Week* and industry publications such as *National Underwriter*.

Year	Source	Garamendi	Gillespie
1988	CA newspapers	196	**152**
	Other papers	5	**28**
	Magazines	0	**3**
	Total	201	**183**
1989	CA newspapers	132	**460**
	Other papers	6	**29**
	Magazines	0	**60**
	Total	138	**549**
1990	CA newspapers	358	**270**
	Other papers	6	**13**
	Magazines	20	**71**
	Total	384	**354**
1991	CA newspapers	**590**	80
	Other papers	**160**	11
	Magazines	**250**	44
	Total	**1000**	135
1992	CA newspapers	**480**	10
	Other papers	**81**	0
	Magazines	**204**	6
	Total	**765**	16

our position; per the NAIC *Troubled Insurance Company Handbook* (June 1989):

> 'Generally speaking, all communications involving troubled insurance companies should be made in an atmosphere of appropriate confidentiality. Knowledge by outsiders of actual or contemplated regulatory activities may cause undue negative consequences to the insurance company ..., and those factors may diminish the insurance company's ability to be helped or to survive.'

Even if regulators were quite concerned about FCLIC's financial condition, it is difficult to rationalize their decision to air their concerns publicly absent political motives to portray themselves as standing up to a large, powerful corporation – American Express – on the junk bond issue.

5.5. *Major parent corporation with 'deep pockets' and its own difficulties*

A complementary explanation for the May 1991 events is that regulators targeted FCLIC because American Express had 'deep pockets' and its own public relations problems that might cause it to accede to Garamendi's demands. American Express/Shearson had appeared in a number of *Heard on the Street* and Allan Sloan columns for their managerial blunders, large writeoffs, earnings problems, and possible capital shortfalls. A writedown of Shearson's FCH stake would further depress earnings and likely therefore generate more bad press (and possible regulatory problems for Shearson).[17] Although the market value of this stake had fallen below $20 million, Shearson took no writedown until FCLIC's seizure, when it wrote off the entire $144 million in book value. A capital infusion or other expression of support might have avoided this outcome.

Why did American Express refuse to provide public support to FCLIC when such support might have minimized the adverse publicity and thus protected the value of its FCH investment? Perhaps American Express feared that by offering support it would acknowledge an obligation of unknown and potentially large magnitude. American Express could have stated publicly that FCLIC was financially sound and did not require a capital infusion but this strategy might have exposed American Express to lawsuits should events have turned out otherwise. FCH, moreover, had corporate governance problems that may also have deterred American Express from offering its support.

5.6. *Corporate governance problems at FCH*

Since Robert Weingarten's resignation in March 1991, FCH had operated without a CEO. Its board, which consisted of two members of FCH management and the four Shearson designates, had named no successor; they simply

[17]During the American Express/Garamendi talks, American Express was the subject of yet another *Heard on the Street* column – 'American Express's Stake in Insurer Is Likely to Mean Another Quarter of Weak Earnings' (*WSJ*, May 10, 1991). The article states: 'Analysts' estimates of potential charges against American Express's earnings begin at around $200 million and run as high as $430 million. While that's manageable for a company of American Express's size and cash flow, it is likely to produce a second consecutive quarter of weak earnings and could force the company to raise more capital... The problem... is that write-offs related to First Capital could wipe out much of Shearson's capital.'

appointed Richard K. DeScherer, a partner at Shearson's counsel, as acting chairman. DeScherer was soon eclipsed by former Shearson CEO Peter Cohen as the de facto but unofficial CEO of FCH (Kerwin and Spiro, 1991b). Cohen's relations with American Express CEO James Robinson were acrimonious at best (Kerwin and Spiro, 1991b; Burrough and Helyar, 1990). American Express may have refused to support FCLIC because FCH either (i) had no effective leader with the clear power to negotiate with American Express or (ii) was represented by an individual with whom American Express management had previously had difficulties.

The absence of a clear line of managerial authority may also have induced FCH's senior creditors, led by Citibank, to move quickly to preserve FCH's assets for creditors when California regulators issued the cease and desist order. FCH's senior creditors were in a weak bargaining position – their collateral was stock in FCLIC and FBLIC – and Commissioner Garamendi had obvious incentives to channel FCH's remaining cash downstream to aid FCLIC. Absent strong leadership at FCH that they knew and trusted, senior creditors could not be sure this transfer would be successfully resisted.[18]

Shearson's interests, moreover, conflicted with those of FCH's other claimants. Why should Shearson contribute $50 million if FCH's 28% stockholder could wait, let regulators seize FCLIC, then use the $50 million to acquire 100% ownership of FCLIC? (This logic assumes that seizure does not destroy material value, but see below.) Shearson was the first bidder for FCLIC after seizure; the outcry from FCH's junior creditors (whose claims would be worthless under Shearson's proposal) led regulators to auction FCLIC to another insurer.

FCH's governance problems are in part traceable to a letter FCH received in early 1991 (apparently sent to firms with material junk bond holdings) from the Securities and Exchange Commission (SEC) requesting additional disclosure about FCH's junk bonds. While management was compiling the required data, several new defaults occurred. These defaults caused FCH management and its auditors to reevaluate the firm's previously announced 1990 results. As a consequence, FCH took additional writedowns for junk bond defaults and intended defaults after year-end 1990 but before the issuance of the 1990 financial statements (the March 15, 1991 earnings reduction discussed in Section 2).

The suddenness and severity of these writedowns made the outside directors question whether FCH management had the situation under control and/or had been completely forthcoming with them about FCH's financial problems. According to our sources, the resultant split between the Shearson designates and FCH's management-directors precipitated the resignation of CEO Robert

[18]According to Feder (1992, pp. 172–173), Citibank was apparently concerned about 'the general uncertainty at FCH, including the possibility of additional management changes, and over the bank's lack of familiarity with (Acting Chairman) DeScherer'.

Weingarten. The Shearson designates' concerns probably impeded the appointment of a new CEO, thereby stranding the firm without a clear line of managerial authority in the midst of a crisis, a leadership vacuum which itself exacerbated that crisis.

5.7. Outcome and value lost

At this writing, FCH remains in bankruptcy, its equity in FCLIC and FBLIC gone (FCLIC was sold to Pacific Mutual Life in January 1993 and FBLIC was sold to ITT's Hartford Life in February 1993).[19] FCH currently has about $30 million in cash, which will likely go to senior creditors, with junior creditors and stockholders getting nothing. This outcome is controversial; the report of the independent examiner appointed by the bankruptcy court (Feder, 1992, p. 268) states: 'Many of the knowledgeable observers believe that FCH has current equity in *each* of the Life Subsidiaries in excess of $100 million.' An unnamed investment banker's report (sealed by the court) estimates FCH's total value at $843.1 million (equity value, $417.4 million) after full payment to policyholders, based on junk bond values close to bankruptcy (Cole, 1992a).

Our own rough estimates indicate that FCH's stockholders and creditors lost between $740 million and $1 billion. The junk bond market turmoil began in mid-1989; in the second half of that year, FCH's stock market value ranged from $367.7 to $659.5 million. By April 30, 1991, however, the value of major junk bond indexes exceeded their levels in the 1989 second half (DDG, 1994, Fig. 3). Thus, considering only changes in junk bond values, $367.7 to $659.5 million is a lower bound on FCH's equity value in early May 1991, absent seizure.[20] Adding the $402.7 million book value of FCH's debt and subtracting FCH's $30 million cash gives an estimated loss of $740 million to $1 billion.

This estimated loss to stockholders and creditors is likely due in part to the actions of regulators and in part to the substantial reduction in new business written by FCH during 1990 because the public had come to view junk bonds as a stigmatized asset class (see Section 3 above and Fenn, 1995). The total loss probably includes both a wealth transfer (to policyholders and/or purchasers of

[19] Pacific Mutual invested $50 million in FCLIC and agreed to guarantee 100% of account balances (plus interest between 4.5% and 6%) to customers who remained with the firm for five years. Pacific Mutual also promised to reduce FCLIC's junk bonds to 5% of assets over the next five years, and to share any profits above its $50 million initial investment with FCLIC's policyholders. Hartford Life assumed FBLIC's liabilities and guaranteed policyholders 100 cents on the dollar if they remained with Hartford Life, and 85 cents otherwise.

[20] FCH's stock market value in early May 1991 was much lower, but this value is not a good estimate of what equity value would have been absent seizure, since it incorporates a discount to reflect the likelihood of regulatory intervention (which was not trivial given the April 11, 1991 seizure of ELIC).

FCLIC and FBLIC) and a deadweight loss from the destruction of FCH's franchise (going concern) value.

6. Lessons from the First Capital case

The factors underlying the demise of First Capital (and the collapse of First Executive that immediately preceded it) offer several lessons about: (1) reputational and informational factors that determine public opinion about the health of financial institutions, thus render such institutions vulnerable to runs, (2) the long-running conflict between Main Street and Wall Street which manifested in these cases as a political backlash against firms that specialized in junk bond financing and investments during the 1980s and, more generally, (3) the politics of finance view that the public's perceptions about corporate policies affect both the cash flows from, and the ultimate viability of, these policies.

Regarding (1), First Capital Life's run developed in response to regulators' negative remarks about the firm, and not because a large number of policyholders conducted independent, detailed financial analyses that revealed serious financial weaknesses. Rather, many customers apparently took regulators at their word and immediately sought to withdraw their funds. One lesson is that the public's perceptions of a firm's financial condition – and not simply its 'true' condition – affect surrender risk. A second lesson is that unconventional investment policies entail risks over and above those associated with investment cash flows *per se*. [First Executive, for example, faced public relations campaigns by competitors seeking to undermine customer confidence in its products (DDG, 1994, Fn. 10).] A third lesson is that mandatory mark-to-market for regulated financial institutions has benefits to the extent that it ensures that regulators do not selectively ignore market value declines for some asset classes or firms.

Regarding (2), the regulatory (media) targeting of First Capital (First Executive) can be analyzed in the framework developed by Roe (1990, 1994), who argues that American populism has generated a century-long series of conflicts between Main Street and Wall Street. Consistent with Roe's general theme, the regulatory and media targeting of junk bond financing and investment specialists during the late 1980s can be viewed as part of a backlash by mainstream America against the perceived economic power of Drexel, its clients, Michael Milken, corporate raiders, etc. An interesting question for future research is whether such targeting is associated empirically with a deliberate public relations campaign by (i) competitors that were locked into long-term investments with inferior returns (in the case of financial institutions that specialized in junk bond investments) or (ii) corporate managements whose tenure was threatened (in the case of junk bond-financed hostile takeovers).

Regarding (3), the First Capital and First Executive cases also support Jensen's (1991, 1993) politics of finance view that the public's perceptions of

particular corporate policies influence the economic impact and ultimately the viability of these policies.[21] These two insurers faced incremental business risks (e.g., of regulatory intervention and/or runs) because they specialized in junk bonds which, in the late 1980s, came to be viewed by the public as inherently undesirable investment vehicles.

In the 1990s, a similar backlash is focused on derivatives, which have garnered a reputation as dangerous financial techniques used by Wall Street 'sharpies' to wreak havoc on unsuspecting old-line corporations and municipalities. The politics of finance argument is also clearly relevant to understanding the strong reaction by the media and government officials to the Christie and Schultz (1994) study of NASDAQ bid–ask spreads and the Asquith, Mullins, and Wolff (1989) study of junk bond default rates. Taken together, these cases suggest that the politics of finance view has broad empirical applicability and is therefore an interesting and important area for future research, incorporating topics such as the public perceptions aspect of derivatives transactions (e.g., the Orange County bankruptcy and controversies involving clients of Bankers Trust), high leverage restructurings, hostile takeovers, wage and layoff policies, and corporate investments in countries suspected of human rights abuses and in unhealthful products such as tobacco.

Appendix

Chronology of key events for First Capital Holdings Corporation, January 1990 through its May 1991 bankruptcy

This chronology was compiled from articles about First Capital Holdings (FCH) or its subsidiaries, First Executive Corporation (FE) or its subsidiaries, and the junk bond market in the *Wall Street Journal* (*WSJ*) or *Los Angeles Times* (*LAT*) from January 1990 to December 1992. *LAT* articles are marked at the end of the article description, which summarizes (our judgment of) the contents, often taken verbatim from the article. The date given is the publication date. The two-day stock return is FCH's raw rate of return over the day before and the publication date, and the closing price is for the last reported trade of FCH's common stock on the publication date. The chronology excludes comparatively unimportant disclosures about FCH. The entries for FE are those

[21] The politics of finance view is also supported by the studies of Dial and Murphy (1995) on compensation policy at General Dynamics and DeAngelo and DeAngelo (1991) on compensation, dividend, and financial reporting policy at large integrated steel firms.

which, in our judgment, likely had implications for FCH's value and/or customers' decisions to surrender their policies and annuities.

Two-day stock return	Closing price	Date	Description of article
− 4.48%	8.00	1/12/90:	Standard & Poor's places FE's preferred stock on Credit Watch with negative implications.
− 7.46%	7.75	1/15/90:	Federated Department Stores, Inc. and Allied Stores Corporation, both controlled by Campeau Corp., file for bankruptcy protection under Chapter 11.
0.00%	7.75	1/17/90:	A California state legislative committee plans to investigate FE's junk bond investment strategies.
− 14.75%	6.50	1/22/90:	FE expects to take a year-end charge of as much as $515 million for junk bond defaults and losses and to post a 'substantial loss' for the year.
− 18.33%	6.15	1/23/90:	Moody's lowers FE's insurance rating to Baa-2 from single A-1.
− 13.46%	5.63	1/24/90:	S&P lowers FE's insurance rating from AAA to A, and FE's preferred stock rating from A to BB + .
2.22%	5.75	1/26/90:	FE says that surrenders increased in fourth quarter 1989, and that it expects further increases.
− 10.42%	5.38	1/29/90:	RJR Nabisco receives lower-than-expected ratings on planned and future debt securities, causing a short-term plunge Friday in both the junk bond and stock markets. This is the first major setback in the company's efforts to pare its huge debt (at 12/31/89, FCH held $58.9 million of RJR Holdings Capital notes, an amount equal to 15.4% of FCH's stockholders' equity at that time).
− 23.91%	4.38	1/30/90:	The junk bond market plunges in reaction to a continued slide in RJR Nabisco bonds.
− 5.88%	4.00	2/14/90:	Drexel files for bankruptcy. Moody's lowers FE's insurance rating three steps (Baa-2 to Ba-2).
6.52%	6.13	3/5/90:	Regulators have had full-time examiners at Executive Life (ELIC) for the last month and have asked outside consultants to study its surrenders.
− 6.38%	5.50	3/12/90:	*Heard on the Street*: Shearson's 28% stake in FCH typifies ill-fated deals of the '80s. FCH's stock, which neared $15 last year, fell to $5.50 in the wake of the junk bond market collapse. Shearson's stake, which cost $120 million, is now worth $74 million.
− 4.17%	5.75	4/3/90:	FE takes more junk bond charges, reports a $835.7 million fourth quarter loss, and says policy surrenders total $559 million in January and February. It also says that regulators ordered ELIC to refrain from junk bond purchases or any major transaction without their prior approval.
0.00%	5.38	4/17/90:	*Heard on the Street*: American Express stock has its supporters despite troubles at Shearson. Shearson's problems include its $500 million bridge loan to Prime Computer, its FCH investment, and its Balcor real estate subsidiary.

Appendix (continued)

Two-day stock return	Closing price	Date	Description of article
– 5.00%	4.75	5/16/90:	FE says it paid out more than $1.33 billion in the first quarter for insurance and annuity surrenders, and that redemptions have slowed since April.
0.00%	3.88	8/15/90:	FE reports a 40% decline in second quarter earnings and a $1.53 billion asset decline, which may in part reflect a surrender increase. Second quarter surrenders are not disclosed.
– 10.00%	3.38	8/16/90:	FE says second quarter redemptions total $1.2 billion, it may omit preferred dividends, and it has approached lenders about a debt restructuring.
0.00%	1.88	10/4/90:	S&P lowers FE's insurance and preferred stock ratings.
0.00%	1.63	11/15/90:	FE says that third quarter earnings fell 55% and surrenders remain sharply higher than a year ago.
– 6.67%	1.75	12/7/90:	New Jersey insurance regulators demand $500 million collateral to allow FE to continue operating there.
– 7.69%	1.50	12/28/90:	*Heard on the Street*: American Express's Shearson troubles linger, say analysts, who foresee future writedowns. One of the concerns is Shearson's FCH investment, now carried at $158 million, which has a current market value of about $20 million. FE agrees not to write new policies in New Jersey.
– 7.69%	3.00	2/15/91:	FE announces it will report 'material' losses for the fourth quarter and the year, and that the market value of its investments fell in the fourth quarter by 4% of total assets (but does not disclose year-end total assets). FE agrees to stop writing new policies in Massachusetts.
3.85%	3.38	3/6/91:	California regulatory filings show declines in capital and assets and increases in redemption payouts and unrealized investment losses at ELIC, whose bond portfolio's market value is $1.54 billion less than its $9.25 billion book value.
0.00%	3.38	3/8/91:	A.M. Best lowers FE's insurance ratings two steps to contingent single B-plus.
– 3.57%	3.38	3/11/91:	Moody's lowers FE's insurance ratings two steps to single B-1.
– 16.00%	2.63	3/16/91:	FCH announces on Friday, March 15 (after the close of trading) that it is reducing its previously announced 1990 earnings, reflecting big problems in its junk bond portfolio. It is also negotiating the sale of its universal life unit to increase capital and Robert I. Weingarten, its longtime chairman/CEO, has resigned (*LAT* on Saturday, stock returns are for the following Monday, 3/18/91).
– 16.00%	2.63	3/18/91:	FCH, stung by defaults in its junk bond portfolio, bolsters its loss reserves by $34.8 million. Its founder and chairman, Robert I. Weingarten, has resigned. Defaults and announced intentions to default are forcing FCH to adjust fourth quarter and full year results for 1990. Adjusted fourth quarter income is a net loss of $24.7 million (down from a previously announced $10.2 million profit). Adjusted income for the full year is $7.2 million (down from $41.9 million).

Appendix (continued)

Two-day stock return	Closing price	Date	Description of article
– 8.70%	2.63	3/25/91:	*Deals* (*Allan Sloan*): Only Ex-Chairman Has Parachute As First Capital Starts Losing Altitude: FCH's stock, which traded in the mid-$20s a few years ago, is now in the $2s and $3s. Its junk bonds trade at distressed prices. Shearson, which holds 28%, won't put more money into the company. It may or may not survive, but Bob Weingarten won't miss a meal (*LAT*). Regulators ask Salomon Brothers to evaluate the worth and probable cash flow of FE's junk bonds.
0.00%	2.88	4/2/91:	FE reports a $465.9 million fourth quarter loss. The year-end market value of its portfolio is $2.6 billion below book value. FE's auditor declined to express an opinion on FE's financial statements because of its questionable ability to survive.
– 4.35%	2.75	4/3/91:	FE's annual report says regulators might require 'material' adjustments to ELIC's capital. It also reports redemptions of $3.5 billion in 1990.
0.00%	2.75	4/5/91:	New York regulators order FE to stop writing new policies and to immediately bolster the reserves of its New York subsidiary by $125 million.
0.00%	2.50	4/12/91:	Regulators take control of FE's California unit.
0.00%	2.38	4/17/91:	Regulators take control of FE's New York unit following a large increase in surrenders after its California unit was seized.
0.00%	2.00	5/6/91:	American Express, which owns 28% of FCH, is talking with the California insurance commissioner about ways to prop up FCH, which has been struggling of late. These discussions, which have been going on for two weeks, raise concerns that FCH is in worse shape than the firm has indicated. FCH holds about 23.5% of its $8 billion of assets in junk bonds, a percent that is likely to be even higher under new reporting rules for insurance companies. FCH has more investments in junk bonds than any other insurer still operating (*LAT*).
– 50.00%	1.13	5/7/91:	California Insurance Commissioner John Garamendi has made little progress in talks with American Express to rescue FCH, and may soon take action against FCH's main insurance unit. FCH has $747 million in paper losses on its $3.15 billion junk bond portfolio at year end 1990 and $120 million of paper losses on other investments. A statutory accounting change had the effect of roughly doubling FCH's reported percent of junk bond investments, from 20% to 40% of assets (*LAT*).
– 25.00%	1.50	5/8/91:	Commissioner Garamendi puts more pressure on American Express to aid troubled FCH which, he claims, needs a substantial cash infusion. Amex has stated that it is only interested in aiding policyholders who are clients of Shearson, which sold more than three-quarters of FCH policies. Garamendi wants Amex to aid all FCH customers. FCH's stock has continued to fall throughout these discussions.

Appendix (continued)

Two-day stock return	Closing price	Date	Description of article
			S&P cut its rating on $120 million of debt to CCC – from BB – and its insurance ratings on FCH's California and Virginia units to BB from BBB +. American Express carries its FCH stake at its $144 million cost, although its market value is $14.6 million. Garamendi's remarks are seen as unusually strong, particularly given his earlier reluctance to publicize FCH's problems for fear of a run. While surrenders have increased, they are still at a manageable level. Garamendi states that FCH needs 'a substantial infusion of cash' to survive and that American Express, as Shearson's parent, must provide the 'full amount of money necessary to stabilize' FCH, which has 40% of its assets in junk bonds (*LAT*).
22.22%	1.38	5/9/91:	Recent news about FCLIC's financial difficulties has prompted a large number of customers to cash in their policies, a situation the California Department of Insurance is closely monitoring due to the potential depletion of reserves. An increase in surrenders prompted California regulators to seize ELIC last month (*LAT*).
– 37.46%	0.94	5/10/91:	California regulators are expected as early as today to sharply curtail FCH operations and ultimately to place FCLIC in conservatorship. This action would halt an apparent increase in redemptions, which strip the firm of cash and can compel asset sales at fire-sale prices. The exact timing of Garamendi's expected move could not be determined. It is believed that redemption demand – already strong in the weeks since ELIC's seizure – soared this week, after it was disclosed that California regulators were negotiating with Amex to rescue FCH. *Heard on the Street*: Analysts believe American Express will not emerge unscathed from FCH's troubles. If regulators seize control of FCH's insurance units, Amex will have to write off an estimated $200 to $430 million. An earnings charge of this magnitude would produce a second consecutive quarter of weak earnings and perhaps force Shearson and/or American Express to raise additional capital.
– 65.89%	0.47	5/11/91:	Halting what he describes as a 'run on the bank', California Insurance Commissioner Garamendi on Friday, May 10 issues a cease and desist order forcing FCLIC to stop selling new policies and to stop honoring surrender requests. Separately, Shearson announces it will write off its entire $144 million stake in FCH. Garamendi blames high operating costs and a large junk bond portfolio for FCH's problems (*LAT* on Saturday, stock returns are for the following Monday, 5/13/91).
– 65.89%	0.47	5/13/91:	California regulators clamp down on FCH's largest insurance operations amid growing concerns about the firm's sudden plunge and the risk of major losses to policyholders. These concerns are bolstered by the fact that both Citicorp

Appendix (continued)

Two-day stock return	Closing price	Date	Description of article
			(FCH's primary lender) and American Express refuse to help recapitalize FCH. Regulatory action is taken to stem a rush of policy redemptions at FCLIC. Analysts are particularly concerned about the company's junk bond portfolio. Separately, American Express says it will write off its entire $144 million stake in FCH. *Deals* (*Allan Sloan*): American Express Lemon: Let us bid farewell to FCH, another creature of the 1980s that foundered in the '90s. An FCH failure would be the second largest in U.S. insurance history, ranking behind only our old friend First Executive Corp., which croaked last month. American Express, whose Shearson subsidiary owns 28% of FCH, is writing off its investment (*LAT*).
− 46.70%	0.50	5/14/91:	Virginia regulators seize FBLIC, the second major FCH unit to be curbed by regulators this week. The action blocks all redemptions but permits routine payments of death and annuity benefits. Moody's lowers FCH's debt rating. Virginia regulators say FBLIC is fundamentally sound. However, after California moved against FCLIC, FBLIC received so many surrender requests, Virginia's Deputy Insurance Commissioner testifies, that without supervision, the further transaction of business could be hazardous to policyholders (*LAT*).
− 20.04%	0.38	5/15/91:	California regulators formally seize control of FCLIC after senior creditors seek to put FCH into involuntary bankruptcy. The petition was filed by Citibank, which is owed $175 million. Garamendi says he would not have seized FCLIC had FCH's creditors not sought bankruptcy. He says he took action to protect policyholders from uncertainties created by the creditors' bankruptcy petition. FE files for Chapter 11 bankruptcy protection.
0.00%	0.38	5/17/91:	*Who's News*: Insurance Chief Achieves Fame Amid Failures: California Insurance Commissioner Garamendi has become the warden of the biggest insurance failures ever; the California subsidiaries of FE and FCH owe more than $14 billion to policyholders and annuitants. Garamendi's ability to handle this and the California car insurance rollback could make him the prototype for future insurance commissioners. 'Should he succeed in rehabilitating the failed companies and cutting auto rates, industry experts say, the darkly handsome and ambitious Mr. Garamendi will have transformed the obscure post of state insurance commissioner into a seat of power and a locus of political change.' FCH confirms that it failed to make a $7.5 million payment on $115 million of its junk bonds. It is already in default on a $275 million loan made by a group of lenders led by Citibank, which earlier this week filed a petition seeking to force the company into involuntary bankruptcy (*LAT*).

Appendix (continued)

Two-day stock return	Closing price	Date	Description of article
33.33%	0.50	5/18/91:	Failed FCLIC lays off 166 of its 400 employees. The layoffs were made in response to regulators' demands to effect significant cost reductions. Additional layoffs are possible if further cost reductions are necessary (*LAT* on Saturday, stock returns are for the following Monday, 5/20/91).
33.33%	0.50	5/20/91:	Garamendi promises to avoid a 'fire sale' of junk bonds from the portfolios of the failed insurance subsidiaries of FE and FCH.
− 16.54%	0.31	5/21/91:	FCH plans to file for voluntary protection under the bankruptcy laws and reports a first quarter loss of $769.9 million (accounting for its seized subsidiaries as discontinued operations). On May 15, FCH failed to make an interest payment on $130 million of senior subordinated debt. FCH's net worth is estimated at − $366.5 million.
− 8.27%	0.34	5/30/91:	California regulators are investigating whether two top officers of the now-failed FCLIC improperly redeemed personal insurance policies or annuities shortly before seizure by the state.
− 27.33%	0.25	5/31/91:	FCH consents to a request by Citibank that the insurer involuntarily be placed under Chapter 11 bankruptcy.

References

Altman, Edward I., 1991, Defaults and returns on high yield bonds: An update through the first half of 1991, Unpublished working paper (New York University, New York, NY).

Altman, Edward I., 1993, Corporate financial distress and bankruptcy (Wiley, New York, NY).

Asquith, Paul, David W. Mullins, Jr., and Eric D. Wolff, 1989, Original issue high yield bonds: Aging analysis of defaults, exchanges, and calls, Journal of Finance 44, 923–952.

Burrough, Bryan and John Helyar, 1990, Barbarians at the gate (Harper & Row, New York, NY).

Cole, Benjamin Mark, 1992a, Analysis claims First Capital can afford its debts, Los Angeles Business Journal, March 16–22, 1, 68.

Cole, Benjamin Mark, 1992b, Examiner blasts Garamendi over seizure of First Capital, Los Angeles Business Journal, March 30–April 5, 1, 56.

Christie, William and Paul Schultz, 1994, Why do NASDAQ market makers avoid odd-eighth quotes?, Journal of Finance 49, 1813–1840.

DeAngelo, Harry and Linda DeAngelo, 1991, Union negotiation and corporate policy: A study of labor concessions in the domestic steel industry during the 1980s, Journal of Financial Economics 30, 3–43.

DeAngelo, Harry, Linda DeAngelo, and Stuart C. Gilson, 1994, The collapse of First Executive Corporation: Junk bonds, adverse publicity, and the 'run on the bank' phenomenon, Journal of Financial Economics 36, 287–336.

Dial, Jay and Kevin J. Murphy, 1995, Incentives, downsizing, and value creation at General Dynamics, Journal of Financial Economics 37, 261–314.

Feder, James J., 1992, Preliminary statement of examination of First Capital Holdings Corporation, First Capital Life Insurance Group, Inc. and Fidelity Bankers Insurance Group, Inc. pursuant to bankruptcy code section 1106 (a), Report dated February 19.

Fenn, George W., 1995, The stigma of junk bonds in the life insurance industry: How do customers of financial institutions assess default risk?, Unpublished working paper (Federal Reserve Board, Washington, DC).

Fenn, George W. and Rebel A. Cole, 1994, Announcements of asset-quality problems and contagion effects in the life insurance industry, Journal of Financial Economics 35, 181–198.

Garamendi, John, 1992, Why I seized two companies, Wall Street Journal, May 12, A17.

Heins, John, 1987, Instant tycoon, Forbes, March 23, 38–40.

James, Christopher, 1991, The losses realized in bank failures, Journal of Finance 46, 1223–1242.

Jensen, Michael C., 1991, Corporate control and the politics of finance, Journal of Applied Corporate Finance 4, 13–33.

Jensen, Michael C., 1993, The modern industrial revolution, exit, and the failure of internal control systems, Journal of Finance 48, 831–880.

Kerwin, Kathleen, 1991, The man behind the mess at First Capital, Business Week, May 27, 92–93.

Kerwin, Kathleen and Leah Nathans Spiro, 1991a, Trying to avoid a sequel to the Executive Life story, Business Week, May 20, 121.

Kerwin, Kathleen and Leah Nathans Spiro, 1991b, Look who's mixed up with First Capital, Business Week, June 3, 116.

Kryzanowski, Lawrence and Gordon S. Roberts, 1993, Capital forbearance: A depression-era case study of Sun Life, Unpublished working paper (Concordia University, Montreal and Dalhousie University, Halifax).

National Association of Insurance Commissioners, 1989, Troubled insurance company handbook, Prepared by the NAIC troubled company working group of the Examination Oversight (EX4) Task Force.

Roe, Mark J., 1990, Political and legal restraints on ownership and control of public companies, Journal of Financial Economics 27, 7–41.

Roe, Mark J., 1994, Strong managers, weak owners: The political roots of American corporate finance (Princeton University Press, Princeton, NJ).

St. George, Karen, 1992, Examiner questions Garamendi's handling of First Capital, The Insurance Journal, April 13, 1–2.

Superior Court of the State of California for the County of Los Angeles, 1991, Application for order of conservation, establishment of procedures, issuance of injunctions and related orders, and memorandum of points and authorities, case no. 2007549, John Garamendi, Insurance Commissioner of the State of California, applicant, vs. First Capital Life Insurance Company, a California corporation, and does 1 through 1,000, inclusive, May 14.

Townsend & Schupp Company, 1991, Liquidity profiles of U.S. life insurance companies for the year ended December 31, 1990 (Hartford, CT).