AmTrust Financial Services losing trust from investors

by Melissa Wong

Note: text in italics highlights revisions made to the article on June 21, 2017

Since its accounting scandals in February, AmTrust Financial Services Inc, a multinational property and casualty insurance company based in New York City, has lost 50% of its market capitalization. In addition, AmTrust's RMI-CRI 1-year Probability of Default (PD) rose to 224.75 bps on June 16, peaking at 254.62 bps on May 31 (see Figure 1). AmTrust has restated its financial statements for the past three years as they contain accounting errors on bonuses paid, foreign currency transactions and revenue associated with administration services. The errors have resulted in the overstatement of about USD 136mn in earnings.

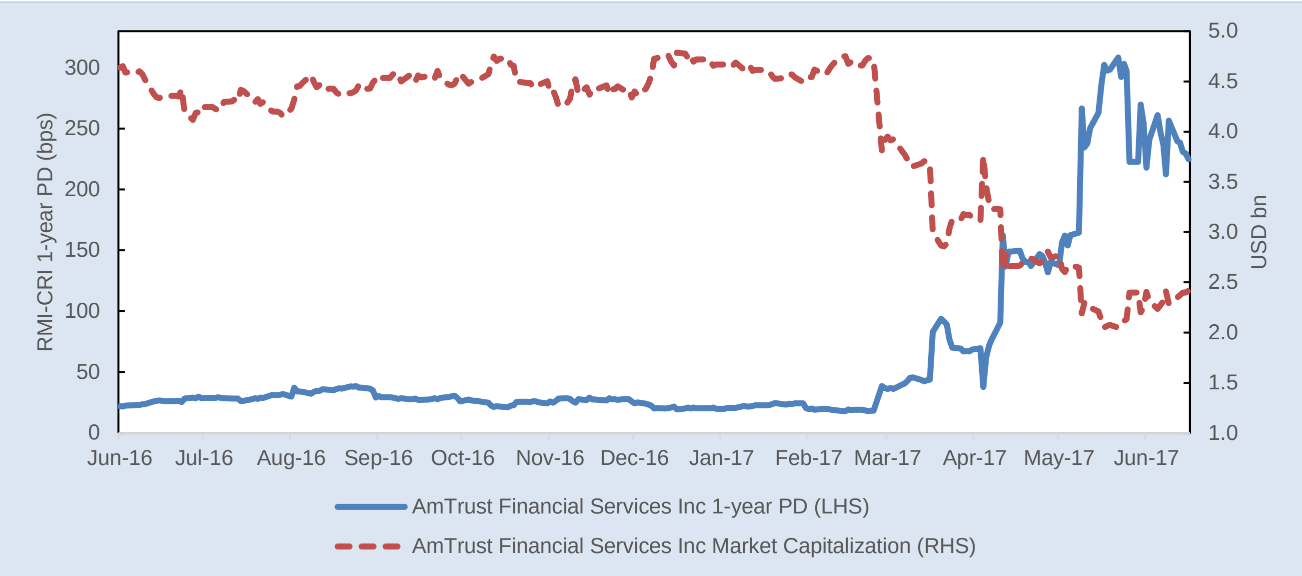

Figure 1: RMI-CRI 1-year PD for AmTrust Financial Services Inc (left axis) and market capitalization (right axis) *Source: RMI-CRI, Bloomberg*

Besides the restatement, AmTrust's financial accounts were also being investigated by the US Securities and Exchange Commission (SEC). The SEC started investigations *on AmTrust's accounting practices* after being tipped off with an audio recording from a whistleblower, who was working with BDO USA LLP as an auditor for AmTrust. Investors lost confidence in AmTrust, leading to a fall in its share price.

In Q1 2017, AmTrust reported disappointing net earnings results due to catastrophe losses worth USD 25mn as compared to a loss of USD 2mn in the previous year. Its net debt to EDITDA ratio rose to 1.93 during the same period (see Table 1). In order to shore up its finances, it conducted a private placement in May. AmTrust managed to raise USD 300mn from family members of its corporate insiders, including CEO Zyskind and board member Karfundel. Both insiders and their family members collectively own about half of AmTrust's business. AmTrust will be using the funds raised to strengthen its subsidiaries and to back its new policies.

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017
Net Income (USD mn)	84.0	134.8	103.6	98.7	22.6
Net Debt/ EBITDA	-0.01	0.37	0.23	1.54	1.93
Free Cash Flow (USD mn)	284.62	-224.67	-13.82	-85.40	-83.83

Table 1: Financial Data for AmTrust Financial Services Inc. *Source: Bloomberg*

In addition to raising funds, AmTrust has recently implemented several measures to beef up its financial capabilities. Firstly, Karkowsky replaced Pipoly as CEO of AmTrust. Karkowsky, who was AmTrust's executive vice president for strategic development, and mergers and acquisition, played an important role in rectifying problems arose from AmTrust's accounting scandals. Secondly, AmTrust sold about 11.5% of its National

General Holdings' shares to unaffiliated third parties for USD 211mn. However, AmTrust's moves failed to boost confidence as investors are still uncertain about its future, especially about AmTrust's insufficient reserves. Analysts from Keefe, Bruyette & Woods suggest AmTrust needs to take on hundreds of millions of dollar worth of reserve charge for policies in its discontinued general liability program to prepare itself in case of situations where the accident losses are greater than expected. The expected losses have been underestimated previously.

AmTrust also plans to divest a 51% stake in its fees business to further shore up its financials. If successful, AmTrust would potentially raise USD 1 bn in excess cash. However, the divestment would be difficult, as private equity houses are unwilling to enter a partnership after AmTrust's accounting scandals.

AmTrust can also commit to better disclosure by having an enlarged board of directors, reconstituted audit committee and an enhanced investor-facing senior management team. With sufficient reserves and improved disclosure, AmTrust might be able to gain back investors' confidence it has lost from its accounting scandals.

Credit News

Greece and creditors reach deal on next part of bailout

Jun 16. Uncertainties clouding Greece's ability to default on more than EUR 7bn worth of debt repayments due next month ended after the country's international creditors agreed on a EUR 86bn bailout. This marked yet another end of dispute between Washington-based IMF and the EU on Greece's debt relief. IMF would only provide financial assistance after the Eurozone details on its commitment to help and the debt relief it is prepared to offer. Some European diplomats and officials preferred to stay cautious, showing certainty only after a careful examination of Greece's actual needs. The debt relief by IMF will amount to USD 2bn – a small figure reflecting the sufficient financial assistance the Eurozone countries should have provided by then to meet Greece's economic needs. The European Stability Mechanism, the Eurozone's bailout fund, will release a EUR 8.5bn tranche of bailout money to cover Greece's debt repayment needs. It will also enable the indebted country to clear arrears and build up a cash buffer. (FT)

U.S. funds balk in rescue of Italy's Monte dei Paschi – sources

Jun 16. Two US private equity funds that were previously in talks to buy bad loans from Italy's ailing lender, Monte dei Paschi, exited negotiations with the bank. The sale of bad loans worth EUR 26mn is a condition the fourth largest lender of Italy must fulfil before a state bailout will be rendered. Sources claimed that there were disagreements over the sale terms and the loans were looking to be sold at around one fifth of its face value. The failure of this deal also complicates plans to bail out two other troubled Italian banks. The only viable alternative for Monte dei Paschi is to turn to Atlante, the Italian banking sector bailout fund. However, Atlante is also in search of private investors to help fund the bailout. The European Commission has agreed to fill a capital shortfall of EUR 8.8bn only if private buyers are willing to buy the EUR 26mn worth of bad loans off Monte dei Paschi's balance sheet. (Reuters)

Takata plans to file for bankruptcy

Jun 16. Japanese air-bag maker Takata Corp. which is noted for producing parachutes for the Imperial Japanese Army during World War II is expected to file for bankruptcy as early as this month. The 84-year-old supplier is expected to seek protection in Japan first before filing its US subsidiary under Chapter 11 bankruptcy. Plans for the filing came following the company's inability to service its mounting liabilities of more than JPY 1tn, most of which are involved in the replacement of more than 100 million of its air-bag devices responsible for at least 17 deaths worldwide. Key Safety Systems Inc., a US air-bag maker owned by China's Ningbo Joyson Electronic Corp. has been recommended as a preferred bidder for this former textile making company. In January, Takata agreed to pay USD 1bn to US regulators, consumers and carmakers consisting of a USD 25mn criminal fine, USD 125mn victim compensation and USD 850mn automakers compensation due to massive recalls. (Bloomberg)

Bond issues could slide for third straight year

Jun 14. Comparing data up to Monday, the value of new Singdollar-denominated bond issuances has decreased to USD 12.5bn so far this year with 61 deals done as opposed to USD 12.7bn from 70 issues last year. This downtrend may be evident as smaller firm with riskier profiles continue to shy away from new bond deals in Singapore, after a series of high-yield bond defaults headlined by the collapse of Swiber last July left investors spooked. According to analysts, the general fall in yields has made investment-grade issuers to raise money at cheaper rates. Furthermore, perpetuities are becoming more popular in the local bond scene as investors are eager to accept higher structural risk and longer tenor. With more bonds redeemed and less new supply, liquidity in the secondary market improved from last year. (Straits Times)

Biggest online lenders don't always check key borrower data

Jun 14. Two of biggest online consumer lenders, Prosper Marketplace Inc. and LendingClub Corp, have been known to occasionally ignore key borrower data when extending loans. According to documents tied to last month bond sales by Prosper, the company does not verify key information like income for around a quarter of the loans it makes. On the other hand, LendingClub only verified income on 35.6% of one of its most popular types of loans in 2016, according to company data seen by Bloomberg. Despite having used machine leaning and other techniques to separate the set of borrower applications to be verified, the company still had to write off 8.5% of its loans in Q1 2017 as compared to 5% on a YoY basis. Unfazed by the disappointing result, LendingClub has again started using new data sources and technology to reduce fraud and improve borrowers' experience with its platform. This is in response to a recommendation for more robust regulatory oversight for online lending by the US Treasury Department. (Bloomberg)

China defaults feared as firms confront short debt addiction (Bloomberg)

India banks to go to court over bad loans of 12 large debtors (Bloomberg)

Regulatory Updates

Swiss banks on track to meet tougher capital rules

Jun 16. UBS and Credit Suisse are on progress to satisfying stricter capital rules intended to improve their loss absorbing abilities. The two banks are already fully compliant with requirements on risk-weighted assets, but have yet to meet the standard on loss-absorbing capacity defined by leverage ratio. The deadline of 2020 had been given to banks to issue bonds and build capital. Tougher rules are designed to help banks withstand extreme economic and financial conditions. This became necessary after the Swiss government had to rescue UBS during the 2008 financial crisis. Since then, UBS had decreased its balance sheet by two third and increased its loss absorbing capital by 40%. The Basel committee are looking to tighten some rules even further, especially rules to restrict the use of internal models for risk evaluation. (Straits Times)

US unveils plans 'that threaten to undermine globally-agreed reforms to make banks safer'

Jun 13. European and Asian regulators are concerned that US plans to upend regulatory changes will create more fragmented regulatory regimes and disrupt the G20's framework to increase country cooperation after the failure of Lehman Brothers in 2008. US banks have welcomed the proposed changes by the Treasury Department, which include easing restrictions on trading operations and reducing the powers of the Consumer Financial Protection Bureau. Observers say that Asian lawmakers could follow the US and delay their Basel III implementation deadlines, which could disrupt the international agreement on the resolution framework for banks. (Reuters)

IBM launches Watson for financial regulation (Fox)

France holds out as bank regulators drive for Basel overhaul (Bloomberg)

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