PENN TREATY AMERICAN CORP
Form 10-Q
June 27, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

[X] Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended **March 31, 2005**

or

[ ] Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from ______________ to _____________

Commission file number 001-14681

PENN TREATY AMERICAN CORPORATION
3440 Lehigh Street, Allentown, PA 18103
(610) 965-2222

Incorporated in Pennsylvania	I.R.S. Employer ID No. 23-1664166

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

The number of shares outstanding of the Registrant s common stock, par value $.10 per share, as of June 13, 2005 was 49,634,555.

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

Penn Treaty American Corporation is one of the leading providers of long-term nursing home and home health care insurance. Our unaudited Consolidated Balance Sheets, Statements of Income and Comprehensive Income and Statements of Cash Flows and Notes thereto required under this item are contained on pages 3 through 13 of this report. Our financial statements represent the consolidation of our operations and those of our subsidiaries: Penn Treaty Network America Insurance Company, American Network Insurance Company, American Independent Network Insurance Company of New York, United Insurance Group Agency, Inc., Network Insurance Senior Health Division and Senior Financial Consultants Company, which are underwriters and marketers of long-term care insurance, Medicare supplement insurance and other senior-market products.

PENN TREATY AMERICAN CORPORATION AND SUBSIDIARIES
Consolidated Balance Sheets
(amounts in thousands, except per share data)

	March 31, 2005	December 31, 2004
ASSETS	(unaudited)	
Investments:		
Bonds, available for sale at market (cost of $59,443 and $58,945 respectively) (1)	$ 58,758	$ 59,171
Policy loans	336	338
Total investments	59,094	59,509
Cash and cash equivalents (1)	15,855	15,296
Property and equipment, at cost, less accumulated depreciation of $11,139 and $10,727, respectively (see Note 8)	17,735	16,925
Unamortized deferred policy acquisition costs	147,258	149,180
Receivables from agents, less allowance for uncollectible amounts of $444 and $474, respectively	932	1,007
Accrued investment income	778	888
Goodwill	6,985	6,985
Receivable from reinsurers	23,850	23,418
Corporate owned life insurance	51,289	51,228
Notional experience account due from reinsurer	914,581	901,368
Other assets	19,339	18,873
Total assets	$ 1,257,696	$ 1,244,677
LIABILITIES		
Policy reserves:		
Accident and health	$ 580,609	$ 568,928
Life	12,932	12,947
Claim reserves	320,295	324,138
Federal income tax payable	545	545
Accounts payable and other liabilities	28,993	24,590
Long-term debt, less discount of $1,256 and $1,426, respectively	78,988	85,167
Preferred interest on early conversion	762	1,403
Deferred income taxes	29,690	29,589
Total liabilities	1,052,814	1,047,307
Commitments and contingencies (see note 4)	--	--
SHAREHOLDERS' EQUITY		
Common stock, par value $.10; 150,000 shares authorized; 47,851 and 44,091 shares issued, respectively	4,785	4,409
Preferred stock, par value $1.00; 5,000 shares authorized, none outstanding	--	--
Additional paid-in capital	143,566	137,288
Accumulated other comprehensive (loss) income	(444)	147
Retained earnings	63,680	62,231
Less 915 common shares held in treasury, at cost	(6,705)	(6,705)
Total shareholders' equity	204,882	197,370
Total liabilities and shareholders' equity	$ 1,257,696	$ 1,244,677

(1) Cash and investments of $32,971 and $31,497 respectively, are restricted as to use (see Note 6).
See accompanying notes to consolidated financial statements.

PENN TREATY AMERICAN CORPORATION AND SUBSIDIARIES
Consolidated Statements of Income and Comprehensive Income
(amounts in thousands, except per share data)

	Three Months Ended March 31,	
	2005	**2004**
Revenues:	(unaudited)	(unaudited)
Premium revenue	$ 79,812	$ 82,288
Net investment income	12,335	10,987
Net realized capital (loss) gain	(1)	221
Market (loss) gain on notional experience account	(588)	35,648
Change in preferred interest on early conversion liability	640	(818)
Other income	1,396	1,621
	93,594	129,947
Benefits and expenses:		
Benefits to policyholders	60,103	59,386
Commissions	9,760	10,421
Net policy acquisition costs amortized	1,922	3,955
General and administrative expense	13,115	13,477
Litigation accrual expense	900	--
Expense and risk charges on reinsurance	2,834	2,807
Excise tax expense	729	783
Interest expense	1,965	3,817
	91,328	94,646
Income before federal income taxes	2,266	35,301
Federal income tax provision	(817)	(12,001)
Net income	1,449	23,300
Other comprehensive (loss) income:		
Unrealized holding (loss) gain arising during period	(912)	739
Income tax benefit (provision) from unrealized holdings	319	(259)
Reclassification of losses (gains) included in net income	1	(221)
Income tax (provision) benefit from reclassification adjustment	--	77
Comprehensive income	$ 857	$ 23,636
Basic earnings per share from net income	$ 0.03	$ 0.79
Diluted earnings per share from net income	$ 0.03	$ 0.32
Weighted average number of shares outstanding	45,104	29,540
Weighted average number of shares and share equivalents	92,884	82,572

See accompanying notes to consolidated financial statements.

PENN TREATY AMERICAN CORPORATION AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(unaudited)
(amounts in thousands)

	Three Months Ended March 31, 2005	2004
Cash flow from operating activities:		
Net income	$ 1,449	$ 23,300
Adjustments to reconcile net income to cash provided by operations:		
Depreciation and amortization	1,651	2,203
Change in preferred interest on early conversion liability	(640)	818
Net realized capital gains	1	(221)
Notional experience account due from reinsurer	(10,061)	(42,432)
Investment credit on corporate owned life insurance	(107)	(241)
Equity issued for interest expense from long-term debt conversions	290	1,805
Increase (decrease) due to change in:		
Receivables from agents	105	125
Receivable from reinsurers	(220)	108
Policy acquisition costs, net	1,922	3,955
Deferred income taxes	420	11,798
Claim reserves	(3,843)	(4,488)
Policy reserves	11,454	13,876
Accounts payable and other liabilities	1,403	1,087
Accrued investment income	110	5
Other, net	(1,381)	(539)
Cash provided by operations	2,553	11,159
Cash flow from investing activities:		
Proceeds from sales of bonds	5,218	15,006
Proceeds from maturities of bonds	705	660
Purchase of bonds	(6,544)	(17,976)
Change in policy loans	2	(12)
Death benefits received from corporate owned life insurance	--	6,423
Deposits to notional experience account due from reinsurer	(3,152)	(21,277)
Proceeds from sale of property and equipment	3,000	--
Acquisition of property and equipment	(1,223)	(1,012)
Cash used in investing	(1,994)	(18,188)
Cash flow from financing activities:		
Issuance of long-term debt	--	16,000
Cash provided by financing	--	16,000
Decrease in cash and cash equivalents	559	8,971
Cash balances:		
Beginning of period	15,296	12,808
End of period	$ 15,855	$ 21,779

See accompanying notes to consolidated financial statements.

PENN TREATY AMERICAN CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2005
(unaudited)
(amounts in thousands, except per share data)

The Consolidated Financial Statements should be read in conjunction with these notes and with the Notes to Consolidated Financial Statements included in the Annual Report on Form 10-K for the year ended December 31, 2004 of Penn Treaty American Corporation (the Company).

The summarized financial information reflects all adjustments (consisting only of normal recurring adjustments) that are necessary for a fair presentation of the financial position and results of operations, comprehensive income and cash flows for the interim periods.

1. Stock Based Employee Compensation:

The following table reflects net income and basic and diluted earnings per share as reported and pro-forma as if the Company had adopted the fair value based method of accounting for its stock-based employee compensation awards:

	Three Months Ended March 31,	
	2005	**2004**
Net income as reported	$ 1,449	$ 23,300
Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(81)	(77)
Pro forma net income	$ 1,368	$ 23,223
Earnings per share:		
Basic - as reported	$ 0.03	$ 0.79
Basic - pro forma	$ 0.03	$ 0.78
Diluted - as reported	$ 0.03	$ 0.32
Diluted - pro forma	$ 0.02	$ 0.32

2. Regulatory Developments:

Pennsylvania Corrective Action Plan

The Company s primary insurance subsidiary, Penn Treaty Network America Insurance Company (PTNA), which represented approximately 90% of the Company s direct premium revenue during the three months ended March 31, 2005, is subject to a Corrective Action Plan dated February 12, 2002 (the Plan), as approved by the Pennsylvania Insurance Department (the Department). American Network Insurance Company (ANIC), which is wholly owned by PTNA, is also subject to the provisions of the Plan.

The Plan principally:

a) required the Company to enter into a reinsurance agreement with Centre Solutions (Bermuda) Limited (the 2001 Centre Agreement) for substantially all of its existing long-term care business at December 31, 2001;

b) limits new investments to those rated by the National Association of Insurance Commissioners (NAIC) as 1 or 2;
c) limits and requires Department approval for affiliated transactions; and
d) required a $125,000 increase in statutory reserves over a three-year period, which was completed as of December 31, 2004.

The 2001 Centre Agreement is accounted for as reinsurance for statutory accounting purposes, but does not qualify as reinsurance under generally accepted accounting principles (GAAP). As the agreement is treated as reinsurance for statutory accounting purposes, it results in the ceding (or removal) of substantially all of PTNA s and ANIC s policy reserve and claim reserve liabilities for statutory accounting purposes.

The 2001 Centre Agreement is subject to certain coverage limitations, including an aggregate limit of liability that is a function of certain factors and that may be reduced in the event that the premium rate increases that the reinsurance agreement may require are not obtained. The Company is required to perform annual comparisons of its actual to expected claims experience. If the Company has reason to believe, whether from this analysis or other available information, that at least a 5% premium rate increase is necessary, the Company is obligated to file and obtain such premium rate increases in order to comply with the requirements of the agreement. If the Company does not file and obtain such premium rate increases, the aggregate limit of liability would be reduced by 50% of the premium amount that would have otherwise been received. The Company is currently in compliance with the agreement.

In the event the statutory policy and claim reserves for the reinsured policies ultimately exceed the limit of liability established in the reinsurance agreement, either as a result of additions to reserves or reductions in the amount of the reinsurer s limit of liability, PTNA or ANIC would have to retain any reserve liabilities in excess of the limit of liability, which could have a materially adverse impact upon their statutory surplus.

New Policy Sales

The Company is licensed and receives renewal premiums from policyholders in all states, but is currently restricted from issuing new policies in 8 states. The Company is approved for sales in Florida, California and Pennsylvania (subject to corrective orders in all three states) which accounted for approximately 17%, 14% and 11%, respectively, of the Company s direct premium revenue for the three months ended March 31, 2005. No other state s sales accounted for more than 10% of the Company s direct premium revenue for the three months ended March 31, 2005.

3. <u>2001 Centre Agreement:</u>

Effective December 31, 2001, the Company entered into the 2001 Centre Agreement to reinsure, on a quota share basis, substantially all of its long-term care insurance policies then in-force. This agreement does not qualify for reinsurance treatment in accordance with GAAP because it does not result in the reasonable possibility that the reinsurer may realize a significant loss. This is due to a number of factors related to the agreement, including experience refund provisions, expense and risk charges due to the reinsurer and the aggregate limit of liability. Accordingly, the contract is being accounted for in accordance with deposit accounting for reinsurance contracts.

The initial premium and future cash flows from the reinsured policies, less claims payments, ceding commissions and risk charges, are credited to a notional experience account, which is held for the Company s benefit in the event of commutation and recapture on or after December 31, 2007. The notional experience account balance receives an investment credit based upon the total return from a series of benchmark indices and derivative hedges that are intended to match the duration of the Company s reserve liability.

The notional experience account represents a hybrid instrument, containing both a fixed debt host contract and an embedded derivative. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the fixed debt host contract. The Company is accounting for the investment credit received on the notional experience account as follows:

a) The fixed debt host yields a fixed return based on the yield to maturity of the underlying benchmark indices. The return on the fixed debt host is reported as investment income in the Statements of Income and Comprehensive Income.
b) The change in fair value of the embedded derivative represents the percentage change in the underlying indices applied to the notional experience account, similar to that of an unrealized gain/loss on a bond. The change in the fair value of the embedded derivative is reported as market gain (loss) on notional experience account in the Statements of Income and Comprehensive Income.

The benchmark indices are comprised of US treasury strips, agencies and investment grade corporate bonds, with weightings of approximately 25%, 15% and 60%, respectively, and have a duration of approximately 14 years. The hybrid instrument subjects the Company s financial results to significant volatility as the estimated value of the embedded derivative is highly sensitive to changes in prevailing market interest rates.

The notional experience account activity for the three months ended March 31, 2005 and 2004 was as follows:

	Three Months Ended March 31,	
	2005	**2004**
Beginning balance		