EMERSON, REID'S

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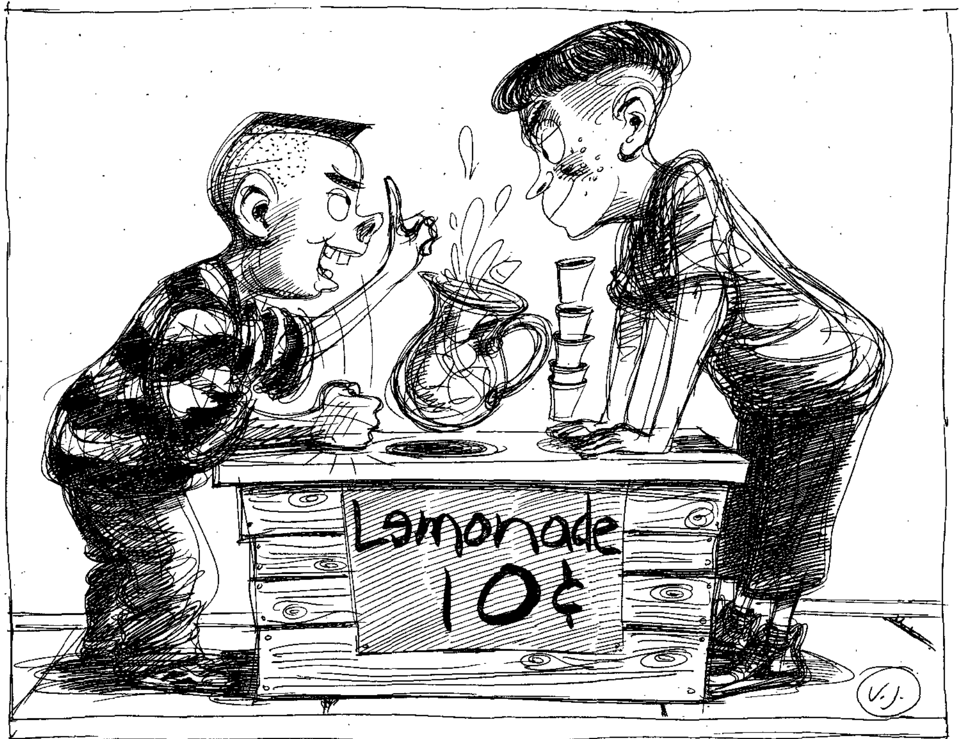
Gala Reinsurance and Catastrophe Issue

Reinsurance Alchemy

If there's any part of the insurance business that can actually be called glamorous, then surely it's the reinsurance business. Reinsurers, unlike primary underwriters, are relatively unencumbered by rules and regulations, and the scope of their business is often international. In general, reinsurance people are better paid, better dressed, and better traveled. They are, in a sense, the financiers of the insurance world and, as such, probably have more in common with investment bankers than they do with auto underwriters, claims adjusters, and property inspectors.

Although the Property/Casualty reinsurance business has been in a cyclical downturn for the last six years or so, the ten largest U.S. reinsurers have posted surprisingly strong results. For 1990, 1991, and 1992, their mean return on statutory surplus was 16%, 17.3%, and 10.5%. A potential investor in the reinsurance business can't help but speculate what the returns might look like during an *upturn* in the cycle.



"I've got it! Let's form a reinsurance company and take it public!"

Despite this show of strength, a reinsurance company is not—at least in theory—a license to coin money. In practice, though, it has become the next best thing (for the moment, anyway) and several recently formed companies have already sold stock to the public at prices significantly higher than their founders paid a short while earlier.

Why is it that well-capitalized reinsurance companies are suddenly as popular as Sharon Stone at a bachelor party? The answer has more to do with the current imbalance between supply and demand than with any secular trend in the insurance industry. After Hurricanes Andrew and Iniki, insurance companies realized the obvious: catastrophes actually happen. They also realized, to their horror, that they were overexposed to catastrophe losses. As a result, primary underwriters began looking for ways to reduce their exposure, or at least lay it off on someone else. Unfortunately, the reinsurance version of musical chairs had come to an end.

Although the resulting shortage of catastrophe reinsurance (and consequent higher prices) is considered positive by most reinsurers and reinsurance investors, there are potential negatives. At a meeting of the Association of Insurance and Financial Analysts earlier this year,

TABLE OF CONTENTS

Gala Reinsurance and Catastrophe Issue

Reinsurance Alchemy: Zurich Reinsurance Centre and Mid Ocean show how it's done • Berkshire Hathaway's Ajit Jain • Catastrophe Reinsurance Price Index 1

The Price Was Right: E.W. Blanch cashes in .. 5

Hugh Hefner, The Sultan of Brunei and the Chairman of Conesco: 6

The Will Rogers of Insurance Rating Agencies: A.M. Best almost never meets an insurance company it doesn't like. • A surprising letter.................................. 7

'An Unreasonable Risk of Insolvency': So says Prudential Property and Casualty. • A.M. Best: wrong again. • Allstate's Probable Maximum Loss—bigger than you might think...... 8

I Was a 'Street'-wise Patsy: David Schiff gets snookered in Hungary. 10

The Insurance Beat: *Insurance happenings from around the world:* Dan Quayle • The 'Bristol Bleeder' • AIG's Laissez-faire, and much more 11

Mark Mosca, Zurich Reinsurance Centre's chief underwriter, discussed "the diverted capital theory," which holds that the casualty market could become even more competitive as "capacity moves from the more immediately dangerous property [reinsurance] to the slower developing but ultimately more deadly casualty." (The counterbalance to this—the "it feels so good theory"—postulates that the "sheer pleasure derived from raising property prices" will motivate reinsurers to raise prices on the casualty side, as well.) Although Mosca saw no evidence of any change in the casualty market at the time, he said, "It's coming. I just don't know when."

When we talked with him recently, Mosca said his outlook hadn't changed. "The casualty market is probably softer now than it was then." He is not predicting when the market might turn, but says that if it continues like this for two or three more years—as he thinks it might—it could lead to the demise of several reinsurers.

Although the current market for catastrophe reinsurance favors sellers rather than buyers, there's no reason to believe that it will *always* be a seller's market, nor is there any proof that greater premiums will not be offset by greater losses.

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Centre Re made seventy-five percent on a $300 million investment—in two months.

That said, several players have recently tapped the financial markets in a display of timing that can best be described as breathtaking. Perhaps the finest example of this breed is Zurich Reinsurance Centre Holdings (ZRC), which was organized on March 3, 1993 by Centre Re and Fund American, who invested $300 million and $40 million, respectively, at $20 a share. Two months and eight days later, a bevy of big-name investment banking firms sold $300 million worth of the company's stock in a public offering at $35 a share—a markup of seventy-five percent. On paper, Center Re and Fireman's Fund made a $265 million profit on their investment.

ZRC will underwrite traditional Property/Casualty reinsurance: working layer excess of loss and pro rata reinsurance treaties. According to its prospectus, ZRC has "no meaningful operating history," although it is staffed by an experienced and highly successful crew of first-rate reinsurance people, none of whom, incidentally, has an employment contract with the company.

Based upon statutory surplus, ZRC is the largest *broker* reinsurer in the country. Although direct reinsurers (General Re, Employers Re, American Re etc.) control fifty-two percent of the reinsurance market (up from 38.78% ten years ago) and have been more profitable, ZRC believes that its size, ability to operate as a lead reinsurer, and willingness to accept large participations on the treaties it underwrites, will give it a competitive edge. Steven Gluckstern, the company's chairman and president, recently said that "overall marketing efforts are not expected to bear fruit until sometime in 1994."

Mark Mosca explains: "We're very cautious of casualty. We're in no hurry; we'll pick our spots. If we don't grow fast for the next couple of years that's fine with us."

One thing that sets ZRC apart from most other reinsurers is an internal policy that "all contracts underwritten will include a limitation on the maximum possible per occurrence exposure." Vice president Elizabeth Richardson explains that ZRC wants to cap its risk at *some* level, even if it's 2,000% of premium. "The cap is there for the bizarre event; it's not meant to interfere with the workings of the policy," she told us. According to her, and others we checked with, caps are not common in the industry. We wondered, therefore, might that not pose a competitive disadvantage to ZRC, even though it makes all the sense in the world?

"In general, an insurance company has to think very carefully about whom it's doing business with," Richardson said, explaining that ZRC, unlike most other large reinsurers, has no "tail." She pointed out that other reinsurance companies might not have adequate reserves for asbestos, pollution, or God knows

Mid Ocean's Largest Shareholders

Shareholder	Number of Shares	Percentage	Value (millions)
EXEL Limited	6,000,000	26.5%	$193.5
Marsh & McLennan Risk Capital Corp.	3,735,438	11.0	120.5
J.P. Morgan Capital	3,050,392	9.2	98.4
H&F Bermuda Partners	2,160,000	6.7	69.7
Kamehameha Schools/ Bernice P. Bishop Estate	1,860,000	5.8	60.0
Fund American	1,318,140	4.1	42.5
Richard Rainwater	931,500	4.2	30.0
Robert Newhouse	306,762	0.9	9.9

Source: *Mid Ocean Prospectus*

what—but not ZRC (because it just started writing business). Richardson speculated that those reinsurance companies that don't cap their limits might not be around to pay claims in the future. (See "Long Tail," page 4.)

ZRC's investment strategy is also intended to limit risk, although one mindless restriction—perhaps designed to placate fearful investors or clients—is typical of insurance company groupthink: investments are restricted to bonds rated "A" or better. If any investment in the company's portfolio is downgraded below that, it must be sold. Exceptions to this policy must be approved by the Board of Directors.

While we're sure the Board will do the right thing, who's to say what the future holds? Having the *flexibility* to invest in lower-rated bonds might one day turn out to be—of all things—prudent.

Although worldwide catastrophe reinsurance capacity has been declining for years—from $350 million in 1988 to $150 million for January 1, 1993—as a result of approximately $1 billion of new capital invested in the industry, capacity should rise to $200-250 million for January 1, 1994. Among the new catastrophe facilities are Renaissance Reinsurance, International Property Catastrophe Reinsurance, Tempest Reinsurance, Global Capital Reinsurance, Partner Reinsurance, and Mid Ocean Reinsurance.

Mid Ocean, which intends to focus primarily on property catastrophe reinsurance, was formed in late 1992 by Marsh & McLennan and J. P. Morgan, the folks who brought us ACE and XL. The company was initially capitalized with $359 million, although, taking into consideration its public offering, capital is now in excess of $600 million. As was the case with Zurich Reinsurance Centre, the public investors paid considerably more—$24.50 a share—in August than the original investors paid—$16.50—last November. (The stock was recently trading at $32¼—a seventy percent premium over book value.)

Although Mid Ocean is now long on capital, it is short on employees. The total staff of this Cayman Island corporation headquartered in Bermuda is eight, but should hit twenty-five by year's end.

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Mid Ocean plans to diversify its exposure throughout the world, and distribute coverage across a range of attachment points. It intends to limit the amount of exposure it will directly write for any reinsurer, as well as the aggregate catastrophe exposure in any geographic zone. Like Zurich Reinsurance Centre, it will operate as the lead reinsurer. Given the nature of its business, Mid Ocean describes its expected loss experience as "low frequency and high severity." For the six months ended April 30, 1993, Mid Ocean's loss ratio was about fifty percent.

While there's no reason to believe Mid Ocean will do a poor job diversifying its risks, or that it will charge inadequate premiums, its prospectus warns that "a single catastrophic event could affect multiple geographic zones," and that "the frequency or severity of catastrophic events could exceed the company's estimates, either of which could have a material adverse effect on the Company's financial condition." Mid Ocean has not ceded any retrocessions so far, and it believes that such coverage isn't available in adequate amounts, anyway.

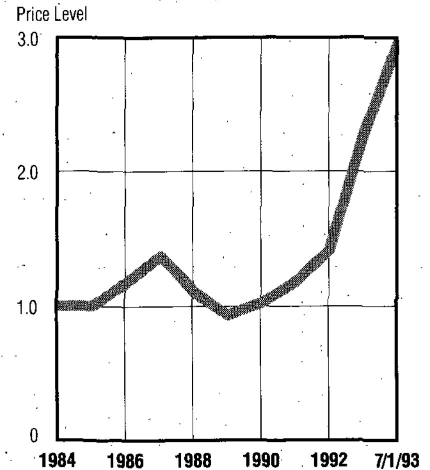
Berkshire Hathaway, the Omaha-based conglomerate controlled by Warren Buffet, is probably the largest writer of "super-cat" reinsurance in the world; 1992 premiums were $125 million. For "super-cat" policies to be activated, two things must generally occur: The policyholder's loss must exceed the retention, and industry-wide losses from the catastrophe must exceed a certain amount—generally $3 billion.

> **"...we can add up our limits by territory and tell ourselves that, no matter how big the Big One is, this is how much we will lose."**
>
> *–Ajit Jain, Berkshire Hathaway*

Ajit Jain, president of Berkshire's reinsurance division, described his company's philosophy at a meeting of the Casualty Actuarial Society: "No matter how big the Big One is, when [it] comes, we want our check to clear and to be left with enough surplus so that we can come back into the marketplace and write business again."

He follows three practical rules: "First, we do not buy reinsurance, because if and when the Big One comes there will be a chain reaction, making it difficult to collect.

"Second, we do not write pro rata business, even with caps." By sticking to excess of loss business, "we can just add up our limits by territory and tell ourselves that, no matter how big the Big One is, this is how much we will lose.



Source: *Reinsurance Trends*, Edgar W. Blanch, Jr.

"The third thing we do is to look at our surplus position and tell ourselves that we ought to be willing to lose as much as the limits we put up. We are not willing to lose anything more than five percent of our surplus per occurrence." Since Berkshire's surplus is in the neighborhood of $10 billion—far more than any other reinsurer—it's willing to risk $500 million per occurrence.

Jain told us that Berkshire is capable of, and does in fact, write catastrophe policies with $100 million limits, something no one else does. "We have an edge because of the quality of our security," he said, explaining that the buyer of a Berkshire reinsurance policy is usually looking for impeccable financial strength. "But the average reinsurance buyer isn't really concerned about credit quality. They don't spend ten seconds thinking about it. They want the cheapest protection and the highest limits."

Catastrophe Program Capacity

Year	Value (millions)
1988	$350
1992	$250
1993	$150–170
1994	$200 (est.)

Source: *Reinsurance Trends*, Edgar W. Blanch, Jr.

If he's correct, and we'll bet he is, that means reinsurance buyers aren't unlike buyers of primary insurance.

Although Berkshire's reinsurance division writes several-hundred-million

Long Tail

HOW MUCH reinsurance do insurance companies have for their environmental liabilities? It's not always easy to tell. CNA, for example, had $1.5 billion in *net* reserves for asbestos liabilities as of June 30, 1993. But what were its *gross* reserves? How much are its reinsurers on the hook for? The company politely refused to provide further information, citing the sensitive nature of the litigation. (CNA has $20.9 billion of Property/Casualty reserves and approximately $3.2 billion in reinsurance recoverable.)

General Re's annual report said that its environmental reserves are $735 million, or eleven percent of its reserves. But when we called up, they, too, declined to provide more information.

Allstate's recent prospectus, however, is more informative. As of March 31, 1993, reserves for asbestos and environmental claims were $806.8 million net of reinsurance recoverable of $679.8 million.

in premiums, it is staffed by just twelve people. "We only handle a couple-hundred transactions a year," Jain explains.

And what is his outlook on the reinsurance industry? "I don't think you've seen the worst of it," he says. "Especially the reinsurance recoverables situation ..."

We agree. ■

The Buyer of Last Resort

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Insurance

Prudential Gives Up Trying To Sell Reinsurance Unit

Will Explore Other Options Including a Public Offering

By GREG STEINMETZ
Staff Reporter of THE WALL STREET JOURNAL

NEW YORK—Prudential Insurance Co. of America gave up trying to sell its reinsurance unit to a private buyer, and instead will explore options including taking the unit public.

Prudential said in March that it was seeking to sell the unit for at least $1.2

IT'S NOT SURPRISING that Prudential was unable to find a buyer for its reinsurance unit. After all, the $1.2 billion asking price was more than double the company's $519 million of surplus. Based on earnings, the price didn't look like a bargain either. Over the last decade, Prudential Reinsurance's aggregate profits were $224.7 million—an average of $22.4 million per year. Although Prudential Reinsurance made money seven of the ten years, when it lost money the losses were big. Even if the $81 million loss in 1984 and the $169 million loss in 1992 are excluded, average annual earnings were only $59 million.

Although no buyer was willing to meet Prudential's price for the whole company, that doesn't mean they won't get their price in a stock offering. The public, after all, has a habit of getting in at the top.

The Price Was Right

E.W. Blanch Cashes In

How much is a reinsurance broker worth? More specifically, how much is a reinsurance broker with $54.6 million in revenues and $9.2 million in after-tax income worth?

If you guessed a quarter of a billion dollars, you were correct—at least on May 6, 1993, the day E.W. Blanch Holdings went public. On that day, insiders availed themselves of the bull market in insurance and reinsurance stocks and unloaded $49.3 million of their own shares, which, apparently, were scooped up by investors who weren't put off by Blanch's negligible net worth and price/earnings ratio of twenty-three.

Minneapolis-based Blanch is one of the leading reinsurance brokers in the United States (it handled $1.4 billion of ceded premium last year), and its clients, who number more than 300, tend to be specialty or regional companies with less than $50 million in surplus. As a result of their relatively smaller size, Blanch's clients—unlike the largest insurance companies—are generally not discretionary buyers of reinsurance. They pretty much *have* to buy it—a plus for Blanch.

Blanch is a good place to work. Nineteen of the company's 329 employees own stock worth more than $2 million, eleven own stock worth more than $1 million, and eleven more own stock worth more than $440,000. But is Blanch a good place for a non-employee to invest his money?

Samuel Liss and Mary Rhei of Salomon Brothers, which underwrote Blanch's public offering, are recommending the stock and projecting that earnings per share will grow twenty percent in 1993. That will be even more impressive than it sounds because fifteen percent of 1992's earnings (about $2.2 million) came from reinstatements of catastrophe coverages related to Hurricane Andrew.

Liss and Rhei are also projecting a thirty-percent earnings increase in 1994, to $1.20 per share. They think Blanch is "well positioned for a cyclical upturn in demand for reinsurance coverage." Edgar Blanch, the company's chairman and largest shareholder, believes the casualty market will firm up in the next twenty-four months. He expects catastrophe property brokerage revenue to increase forty-five percent this year, to $14.5 million. Demand from clients is such, however, that, were capacity not limited, revenues might have been $18.5 million.

Over the last five years, Blanch's revenues have increased forty-one percent but earnings per share have grown 300%, as the company's operating margin has almost tripled from ten percent to twenty-eight percent. But are these profit margins sustainable over the long term in a highly competitive business? Won't they shrink as the company grows? Guy Carpenter's margins, for example, have been under severe pressure the last six years.

Put simply: Is the reinsurance business—and Blanch's reinsurance brokerage business—really on the verge of a boom, or is Wall Street simply in the midst of an outbreak of Reinsurance Euphoria? And, if Blanch's stock is such a good buy, why did its fifty-one shareholders choose to lighten up on the offering or shortly thereafter? That last question is, of course, somewhat rhetorical since these shareholders had paid, on average, $1.25 per share, and the opportunity to sell a portion of their holdings at $18.50 was undoubtedly tempting.

Perhaps our skepticism is misplaced; it's the optimists, after all, who tend to succeed. Perhaps everything will go right for Blanch: revenues may soar, expenses may remain in check, and the casualty market may be accommodating. Perhaps fifteen times *projected* 1994 earnings is a fair price to pay for the stock. And perhaps Blanch's sky-bound earnings trajectory will continue for years and years.

On the other hand, maybe things won't work out that neatly. Maybe earnings will only grow ten percent. In that case, Edgar Blanch's sale of thirty-nine percent of his stock for $27.4 million may seem especially shrewd. ■

E.W. Blanch's stock was recently trading at $21¼, up fifteen percent from the offering.

Hugh Hefner, The Sultan of Brunei, and the Chairman of Conseco

It's the Shoes. (Or Is It the Jet?)

Bijan, the ultra-swanky men's store where suits start at $3,500 and the least expensive shoes, shirts, and ties will set you back $950, $750, and $220, respectively, recently bought full-page ad in *Vanity Fair* to salute "250 men with timeless good taste, style and power."

Among the names on the list were such fashion plates (and Bijan clients) as The Sultan of Brunei, Neil Sedaka, Hugh Hefner, Prince Saud Khalid Al-Saud, Merv Griffin and Stephen Hilbert. *Stephen Hilbert,* the chairman of Conseco, the rapidly growing purveyor of annuities? Yes.

Mr. Hilbert can afford to fill his house with Bijan's goods; he controls Conseco shares worth $160 million, and his compensation, which tipped the scales at $10.4 million last year, should be even higher this year. In addition, he has a $1.9 million interest-free loan from the company that need not be repaid until the year 2000, at the earliest.

Conseco has been enormously successful buying life insurance companies and consolidating them, and earnings have grown rapidly. The company professes to keep costs low by "sticking to the basics" and tells shareholders that operating expenses are under "firm control." While that may be, Conseco does have a fancy corporate jet and several other airplanes. Although a small air force can be mighty handy at times, it is usually thought of (by folks like us) as an executive perq.

Curious to learn more about the inner workings of the insurance business, we called Conseco to ask about their planes: How much did they cost? What kind of food is served? Has Bijan flown on them? Our repeated inquiries fell on deaf ears.

It's always intriguing when an insurance company opts for the lavish touch. Financial history is littered with companies that forsook frugality and came to regret it. We recall what Peter Hutchings, executive vice president and chief financial officer of Guardian Life, told us while we sat his sparse office in the company's cheap-but-functional headquarters in the low-rent district: "We can't control mortality or investment returns, so we have to be careful with expenses."

While The Guardian may be an extreme example of a penny-pinching life insurance company, a Spartan existence is not for everyone. Still, the question remains: Why does Conseco need a jet?

Perhaps the answer was supplied by one of our subscribers. He follows Conseco closely, has visited its headquarters, flown on its planes, and is, incidentally, a shareholder. "Hilbert's jet is *really* nice," he quipped, "although it looks kind of like the plane you'd buy if you'd never gotten laid and wanted to impress the girls." ■

High Fliers: A Survey of Leading Life Insurance Companies

Does your company own any aircraft?

Company	Response
Prudential Insurance	Yes[1]
Metropolitan Life	Yes
Teachers Insurance & Annuity	No
Aetna Life	Yes[2]
New York Life	No
Equitable Life	No
Northwestern Mutual	Yes[3]
John Hancock Mutual	No
Principal Mutual Life	Yes[4]
Massachusetts Mutual	Yes[5]
Lincoln National Life	Yes[6]
Mutual of New York	No
New England Mutual Life	No
Conseco	Yes[7]
The Guardian	No

1. A Gulfstream 3 and a Sikorsky helicopter.
2. Two jets and two helicopters.
3. One jet. Used primarily by investment department and agency department, as well as senior executives.
4. A King Air 200 turboprop and a Falcon 20 jet.
5. One helicopter. Used to shuttle employees between New York and Springfield.
6. One turboprop and two Lear 35s.
7. At least one jet and one plane. Wouldn't provide details.

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Company	Name & Title	1992 Compensation
Equitable Life	Richard Jenrette, CEO	$8,223,316
Prudential Insurance	Ron D. Barbaro, President	3,394,923
Metropolitan Life	Robert Schwartz, President	2,919,141
Teachers Insurance	Clifton Wharton Jr., CEO	1,427,278
New York Life	G. Bundschuh, President	1,136,160

Source: *The Insurance Forum*

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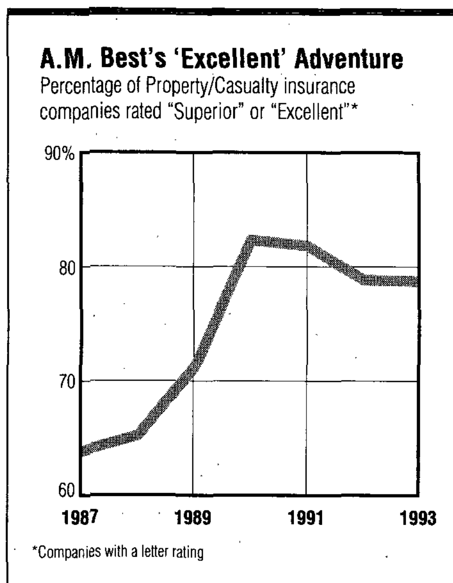
A.M. Best Almost Never Meets an Insurance Company It Doesn't Like

Although A.M. Best has had a near monopoly on the insurance-company rating business for a long time, its reputation and dominance have begun to erode in recent years. Despite its noble Mission Statement—"To perform a constructive and objective role in the insurance industry towards the prevention and detection of insurer insolvency"—Best's was blindsided by the two largest insolvencies of all time, Executive Life and Mutual Benefit, and its methodology has been questioned because its ratings are rarely unfavorable. For example, of the 2,471 companies that received a letter rating in 1993 (Property/Casualty and Life/Health combined, excluding companies under state supervision or in liquidation) only fifty-three were rated "Fair" or "Marginal." The vast majority—1,901 or seventy-seven percent—were rated "Superior" or "Excellent." As the accompanying chart indicates, a significantly larger percentage of Property/Casualty companies now have Best's highest ratings than in 1987.



This seems somewhat at odds with a comment that Jack Snyder, Best's senior vice-president, made to *Business Week* regarding insurers' potential liability for environmental claims: "If Superfund was to get very aggressive, it could potentially jeopardize or impair some of the big household names."

It seems even further at odds with Best's *Review of 1992 P/C Trend and Rating Changes*, which noted that the industry is underreserved by $39 billion (twenty-four percent of surplus), on a "collision course" as a result of lower investment returns and underwriting losses, and "more vulnerable to large-scale disasters than at any other time in the past." (For more on catastrophes and their potential effects on insurance companies, see "An Unreasonable Risk of Insolvency," page 8.)

Given these dour prognostications, how can Best's keep churning out such cheerful ratings? And, when almost all companies receive "superior" or "excellent" ratings, how do you tell the strong from the weak? Rhonda Ruch, Director of Public Relations at A.M. Best, attempted to answer our questions.

"They are still financially strong," she said, referring to the largest companies, adding that Best's watches them more closely than ever. "Years ago the process was a once a year thing, but now we monitor it year 'round. Companies are rated three times a year—annually, after six months, and after nine months."

Jack Snyder was also nice enough to spend some time trying to enlighten us. "Since 1987 there's been a downward trend; financial strength has deteriorated. We're cognizant of some the industry's exposures, but we temper those, and weigh them in our judgment," he said, sounding a little like a statesman. "This isn't going to bankrupt companies, but maybe some of the 'excellent' companies will be 'very good' in the future."

Try as we might, we couldn't get Ruch or Snyder to admit that many companies don't really deserve their ratings, nor could we get them to say that Best's tries too hard to remain in the industry's good graces.

Along those lines, however, it's worth taking a gander at a letter passed on to us by a subscriber. The letter was written on December 6, 1991 by Richard L. Hall, vice president of A.M. Best, and is addressed to George V. Whitford. Mr. Whitford wrote a lighthearted column for *Best's Review* entitled "The Devil's

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Richard L. Hall
Vice President

December 6, 1991

Mr. George V. Whitford, President
Whitford Group Associates
201 W. Evergreen Ave.
Philadelphia, Pa. 19118

Dear Mr. Whitford:

Doris Fenske has asked me to respond to your December 1 letter. I am not sure I can add anything to what Doris already said to you last month. You asked for a frank response and I will try to give you an accurate account of our conversation about

"It is not the policy of the A.M. Best Company to criticize the insurance industry in any form or manner in our publications."

Although we realize your column is intended to be subtle humor, certain definitions easily could be offensive to some individuals. Mr. Snyder's primary concern was the sensitivity of these subscribers.

Doris and I had a long discussion about the possibility of editing some of your definitions, but we rejected this option in fairness to your style and originality. Therefore, I made the decision to discontinue the column.

All of us at Best's Review want to thank you for your contribution to the magazine and wish you success in finding another firm to publish your dictionary.

Sincerely,

Richard L. Hall

cc Arthur Snyder
Paul Wish
Doris Fenske

A.M. BEST

A shocking admission

Dictionary." ("Back office," for example, was defined as "Populated by an army of technicians who eschew the front office and shrug their shoulders when disciplined. The tail that wags the dog.") When *Best's Review* canceled his column in 1991, Mr. Whitford, who has worked in the insurance industry for over fifty years, asked why—in writing. Mr. Hall's response is illuminating:

> "Our publisher, Arthur Snyder [Editor's note: Mr. Snyder is also the president of A.M. Best] asked me to either edit certain definitions in your column that are critical of insurance industry management or remove the column entirely. It is not the policy of the A.M. Best Company to criticize the insurance industry in any form or manner in our publications. Although we do report adverse conditions and events which the industry may find objectionable, we attempt to provide a balance and base our articles on solid facts.
>
> Although we realize your column is intended to be subtle humor, certain definitions could be offensive to some individuals. Mr. Snyder's primary concern was the sensitivity of these subscribers...."

If Best's is reluctant to criticize insurance industry management even in a gentle, humorous way, how must it feel about issuing negative ratings?

A 'Non-Event'

One could say the matter of Best's ratings is largely theoretical, anyway. In "The Effects of Best's Rating Changes on Insurance Company Stock Prices," a study published in *The Journal of Risk and Insurance*, Iowa State University professors Ajai Singh and Mark Power concluded that Best's rating changes are "a non-event in terms of new information conveyed to the market," and that Best's is really just "a monitoring agent of publicly available information."

Although Singh and Power were writing in the context of the stock market rather than the insurance marketplace, it's safe to say that Best's is not the first to know when something is going wrong, and that those relying on Best's (and perhaps any rating agency) are virtually guaranteed to get outdated information of adverse changes in an insurer's financial condition.

In light of all this, we'd like to add "insurance rating agency" to "The Devil's Dictionary," and define it as "an arcane monitoring service that analyzes insurance companies and rates them all highly—until it's too late." ■

'An Unreasonable Risk of Insolvency'

PRUPAC says it's in trouble. A.M. Best says it isn't.

Although Hurricane Andrew, which caused $17 billion in damage, was the most costly insured catastrophe of all time, it could have been *much* worse. Applied Insurance Research in Boston has projected that a Class 4 or 5 hurricane could cause $52 million in damage if it hit Miami or Fort Lauderdale. While that's a mighty big number—almost one-third of the Property/Casualty industry's surplus—not all companies have a disproportionate exposure to catastrophes. However, some of the largest insurance companies have been operating for years without understanding the risks they were taking, and, consequently, underpricing coverage.

So how does an interested observer of the insurance industry uncover an insurance company's exposure to catastrophes? Not easily. Most do not reveal their Probable Maximum Loss, although Prudential Property and Casualty (PRUPAC) recently disclosed theirs in a lawsuit brought against the State of Florida and the Department of Insurance, which has prevented PRUPAC (and other insurance companies) from non-renewing homeowners policies in areas where it has an inordinately high concentration of risk.

You may remember that PRUPAC was, as a result of its heavy concentration of policyholders in Dade and Broward counties, rendered insolvent by Hurricane Andrew (its $578 million of policyholders surplus was dwarfed by $1.3 billion in losses) and required a $900 million capital infusion from its parent to restore solvency and avoid liquidation.

According to the lawsuit, PRUPAC has commissioned two "independently developed state of the art computer simulations of its probable maximum loss from a hurricane coming ashore." Both simulations projected losses of $1.5 billion, far more than the $400 million that PRUPAC could withstand without being impaired. Although PRUPAC's policies contain contractual terms that permit the company to issue non-renewal notices, the insurance department won't let the company off the hook.

There's an irony to the state's actions. If PRUPAC wanted to do something reckless like invest all its assets in junk bonds, or write at a twenty-to-one premium-to-surplus ratio, it wouldn't be allowed. The state, however, sees no inconsistency in *forcing* PRUPAC to take on too much homeowners insurance, exposing the company, in its own words, to "an unreasonable risk of insolvency."

There are other issues raised by this situation, although we have a feeling we're the only ones raising them. If, as PRUPAC has declared, it runs "an unreasonable risk of insolvency," why would anyone choose to buy insurance from it? Obviously, Florida policyholders have nowhere else to turn, but policyholders in most other states surely have alternatives.

Furthermore, should applicants for PRUPAC policies be warned that the company runs "an unreasonable risk of insolvency?"

More importantly, why is a company that runs "an unreasonable risk of insolvency" still rated "A–" by Best's? Jack Snyder of A.M. Best explained that PRUPAC's rating is conditioned upon the situation being worked out with the state of Florida. "If, on November 15 [the date the moratorium on non-renewals will supposedly end] PRUPAC isn't allowed to move forward with its plan, it will not be an 'A–' company," Snyder told us. He believes the situation will be resolved and that PRUPAC (and others) will be allowed to non-renew some of their business over a few years and phase in rate increases as well.

Regardless of what Snyder thinks may happen in the future, PRUPAC's policyholders are currently taking a much greater risk than one would expect to take from an "A–" company. (Best's says "A–" companies have "a

strong ability to meet their obligations to policyholders." By its own description, PRUPAC does not fit this criterion.) Snyder told us that there was an expectation that Prudential would stand behind PRUPAC, but Peter Price, PRUPAC's spokesman contradicted this, saying simply that "There are no guarantees" that Prudential will bail out the policyholders if there's another catastrophe.

If Best's were to act like a leader rather than a statesman, and were it to put its subscribers' interests ahead of insurance companies' (one expects no less from a rating agency) then it should, at the least, suspend PRUPAC's rating, or significantly downgrade it, until the situation is resolved.

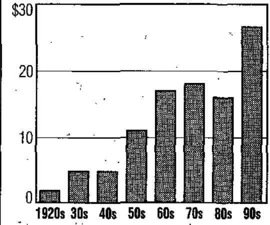
Hurricane Watch

During the past thirty-two years, only fourteen hurricanes have hit Florida. In the previous ninety years, however, hurricanes hit Florida once a year, on average. Since 1969, three intense hurricanes have hit Florida. (Camille in 1969, Hugo in 1989, and Andrew in 1992.)

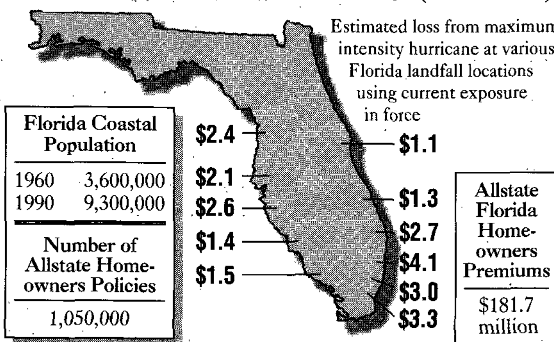
Average Annual Hurricane Activity (1950-1993)*	
Named Storms	10
Named Storm Days	47
Hurricanes	6
Hurricane Days	24
Intense Hurricanes	2.5
Intense Hurricane Days	5.5

*Not all hurricanes hit land

U.S. Hurricane Damage Per Decade
(in billions of 1990 dollars)



Allstate's Probable Maximum Loss (in Billions)



Florida Hurricanes (1881-1992)	
Wind Speeds	Landfalls
Up to 115 mph	57
116-135 mph	13
136-155 mph	7
Over 155 mph	3

Hurricane Categories	
Category	Wind Speeds
1 (Minimum)	74–95 mph
2 (Moderate)	96–110 mph
3 (Extensive)	111-130 mph
4 (Extreme)	131-151 mph
5 (Catastrophe)	Over 155 mph

Sources: Allstate; Dr. William Gray, Colorado State University; Applied Insurance Research; U.S. Census Bureau

Allstate Insurance Company was not busted by Hurricane Andrew, but it was severely tested. The 121,000 loss reports it received required the services of 2,440 claims people, and its $2.7 billion in losses ($2.5 billion after reinsurance) was fifteen times its 1992 Florida homeowners premiums.

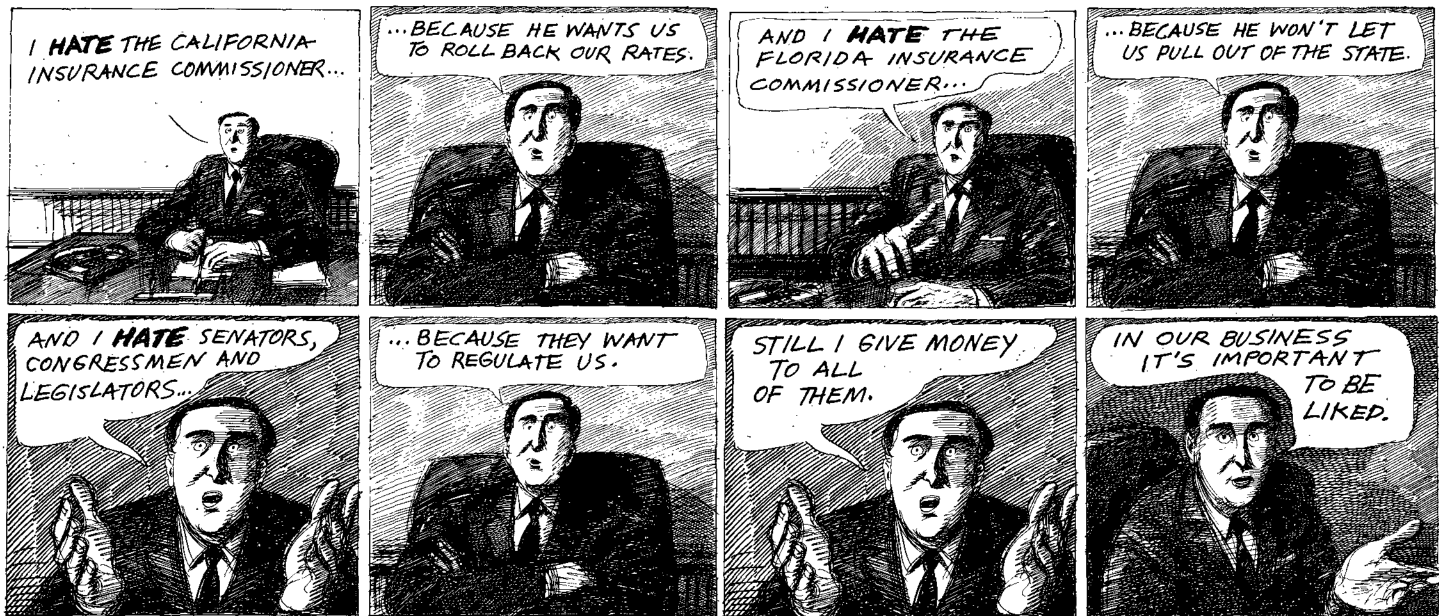
Like PRUPAC, Allstate had foolishly bitten off much more than it could chew. Allstate's mistake is all the more inexplicable considering it had spent $1.7 billion over the previous five years on technology designed, among other things, to *"improve its risk selection capabilities."*

In testimony before the Florida Department of Insurance, Allstate said a Class 5 Hurricane hitting Broward County could cause it $4 billion in losses and "create serious concern for our financial condition." (Allstate currently has no catastrophe reinsurance, and its "A-" Best's rating is in jeopardy if the company can't come up with a workable plan in the not-too-distant future.)

Not surprisingly, Allstate wants to reduce its hurricane exposure in Florida—to $1 billion (16.6% of surplus) per storm. The company says this is equal to the loss it would expect from a major earthquake along the San Andreas Fault. (This sounds extremely low to us.)

Allstate says it has "developed a sophisticated computer model" to weed out policies in eighteen coastal counties with the highest exposure to hurricane loss. All told, Allstate wants to non-renew 300,000 of its 1,050,000 Florida homeowners policies. No place would be more affected than Dade County, where Allstate wants to non-renew 66,700 of its 88,900 policies.

Although Allstate is worried about losing $4 billion in a big hurricane, the stock market has shrugged off this concern. In July, Allstate raised more than $2 billion by selling shares at $27. At a recent price of $32, Allstate has a market capitalization in excess of $14 billion. ■



Confessions Of A 'Street'-wise Patsy

By David Schiff

There's an old poker saying: "If you've been in the game for half an hour and don't know who the patsy is, *you're* the patsy."

As an avid observer of financial folly, I know that greed is the cause of most money-losing speculations. Greed turns people into patsies.

Throughout the latter half of the Roaring Eighties, people were bored silly by my grumblings about the dangers of excessive leverage, easy credit, and nutty deals. "Do you really think my insurance company is going under?" a friend once asked nervously, knowing I'm the sort who decorates his office walls with the bonds of bankrupt railroads and utilities.

Because my economic outlook was out of sync with the prevailing zeitgeist, I was good for a laugh at dinner parties. "Don't mind David," friends said. "He doesn't like anything."

Having spent time on Wall Street, I know one thing: there the customer is always the patsy. Brokers have peddled all sorts of harebrained ventures because patsies love the idea of easy money. In 1920, Charles Ponzi, the Abner Doubleday of pyramid schemes, promised his patsies a fifty percent profit on their investment every ninety days. He took in $15 million. By the 1980s, the price of patsyism had declined to the point where junk bonds only had to offer a few hundred basis points over Treasuries to reel in $200 billion. As many large insurance companies proved, it's not only the little guy who's a patsy.

During a trip through Eastern Europe in 1990 I must have been lulled into complacency by the strong dollar and low prices. Little did I realize I would soon violate two cardinal rules of investing: stay away from things you don't understand, and things that seem too good to be true usually are.

We arrived in Hungary on a weekend and, since the banks were closed, cashed some travelers checks at the hotel desk. Although the official exchange rate was sixty forints to the dollar, I got considerably less after the cashier took his cut.

It wasn't long, however, before the opportunity to make a quick profit on a currency exchange presented itself. On a downtown street, a young couple asked us if we'd like to change some money. They spoke English well, which is unusual in Eastern Europe.

"What's the exchange rate?" I asked.

"Eighty forints to the dollar."

This was going to be arbitrage at its finest—risk free and rewarding. Easy money.

I stepped around the corner to complete our transaction. In the back of my mind I remembered a guidebook's warning not to change currency illegally. I ignored it.

I took five new twenties out of my wallet and held them in my hand. The young man pulled out a huge wad of bills and began thumbing through them. He seemed to be having difficulty finding the right ones and looked over his shoulder nervously. Considering the average Hungarian's daily wage is less than the cost of two Big Macs, the size of his wad surprised me. Finally he peeled off two 5,000s and we made our trade.

I rejoined my friends, quite pleased with myself. "I got a hundred forints to the dollar," I said. "Incredible, isn't it." Only then did I inspect the money. What was Marshal Tito, the former Yugoslavian leader, doing on my newly acquired Hungarian forints?

He was there because I was the patsy. Naturally, the young couple was long gone.

Later, the cashier at our hotel smiled politely and shook his head when I asked if my Yugoslavian dinars were worth anything.

But he was wrong. They were a cheap lesson. Right now I'm keeping them next to my Insull Utility Investments ten-year 6% gold debenture due January 1, 1940. That bond defaulted in 1932 when Samuel Insull's highly leveraged utility holding empire came crashing down.

I'm reminded of Insull's erroneous lament thirteen years earlier: "Bankers will lend you umbrellas only when it doesn't look like rain."

If you don't want to be the patsy, that's not a bad policy. ■

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The Insurance Beat

Lloyd's KOs 'Bristol Bleeder'

TO PAY FOR LOSSES he suffered as a Name at Lloyd's, Henry Cooper, the 1960s British heavyweight champion who once knocked down Muhammad Ali, was forced to sell his three championship Lonsdale Belts at a Sotheby's auction of sporting memorabilia. *Grant's Interest Rate Observer* reported that the belts brought in £42,000, forty percent less than expected.

A&A Explains

ALTHOUGH Alexander & Alexander has been in business since 1898, as of December 31, 1992, it had a retained earnings deficit of $83.2 million. That prompted the following unusual disclosure in the "Liquidity and Capital Resources" section of its 1992 annual report. "Under Maryland law, dividends may be paid as long as, after giving effect to the dividend, a corporation is able to pay its debts as they come due in the usual course of business and total assets of the corporation exceed total liabilities plus any preferential right of stockholders upon dissolution of the corporation. The Company's current financial position satisfies these requirements...."

'Thirty Cents On the Dollar'

LOUISIANA Insurance Commissioner Jim Brown said his state's Guaranty Association, which pays the claims of insolvent insurers, "is so broke it can only pay out thirty cents on the dollar." To help make up the shortfall he's going after lawyers whose legal advice led to fraud or insolvency.

"My advice to lawyers," he said to a roomful of them at the American Bar Association's annual meeting, "is to counsel your insurance company client as if you owned the company. When you represent insurance clients in our state you have a strong obligation to be aware of everything from mistakes to outright fraud. I'm going after every dollar I can get, and that means vigorous pursuit of accountants, bankers and lawyers who received fees for advice and professional services in furtherance of insurance schemes."

Mouthpieces beware.

Potatoe Life Insurance Co.

DAN QUAYLE wants to buy life insurance companies, especially in Indiana and the Midwest. *The Indianapolis Star* reported that Quayle will serve as chairman of Circle Investors, a recently formed financial services company in Indianapolis that will be looking for acquisitions in the life insurance industry.

The company's chief executive officer, R. Matthew Neff, former chairman of the Federal Housing Finance Board, described Circle's strategy to the *American Banker*. "We are going to take life insurance products and build them out," he said. The company plans to develop new products "so that families will be better able to handle the major financial events in a life: educating children, long-term health care, and retirement financial needs."

The former vice president, who was often considered as lacking the intellectual capacity to be president, was not available for comment to *Emerson, Reid's Insurance Observer*. However, one of his poignant observations undoubtedly holds true for his new venture: "If we don't succeed," Quayle once said, "we run the risk of failure."

Best of luck in the insurance business.

Laissez-faire?

AIG's Chairman Hank Greenberg is a proponent of the free market—sometimes. In his company's 1992 annual report he writes about "the necessity for market-oriented solutions to problems of insurance price and availability" and says that no less than "the future competitiveness of American business" depends upon "our ability to strip away bureaucracy, while reinforcing the principles of market economics." He also decries the judicial system, saying it "too often seeks to substitute a universal 'safety net' for the principles of individual responsibility."

On the other hand, he's not opposed to a loan from the U.S. Treasury should disaster arise. He says a catastrophic earthquake or windstorm is "beyond the capacity of the insurance industry"—only the Federal government can cushion the economic shock of such a thing. He advocates passage of a bill to create a Federal fund to deal with catastrophic natural disasters. The fund would be financed by a premium tax, "not taxpayer dollars." However, if the fund had inadequate capital (as it undoubtedly would if a catastrophe struck soon) it would be "authorized to borrow from the U.S. Treasury to satisfy claims."

Did someone happen to mention "market economics"? ■

Can You Believe It?

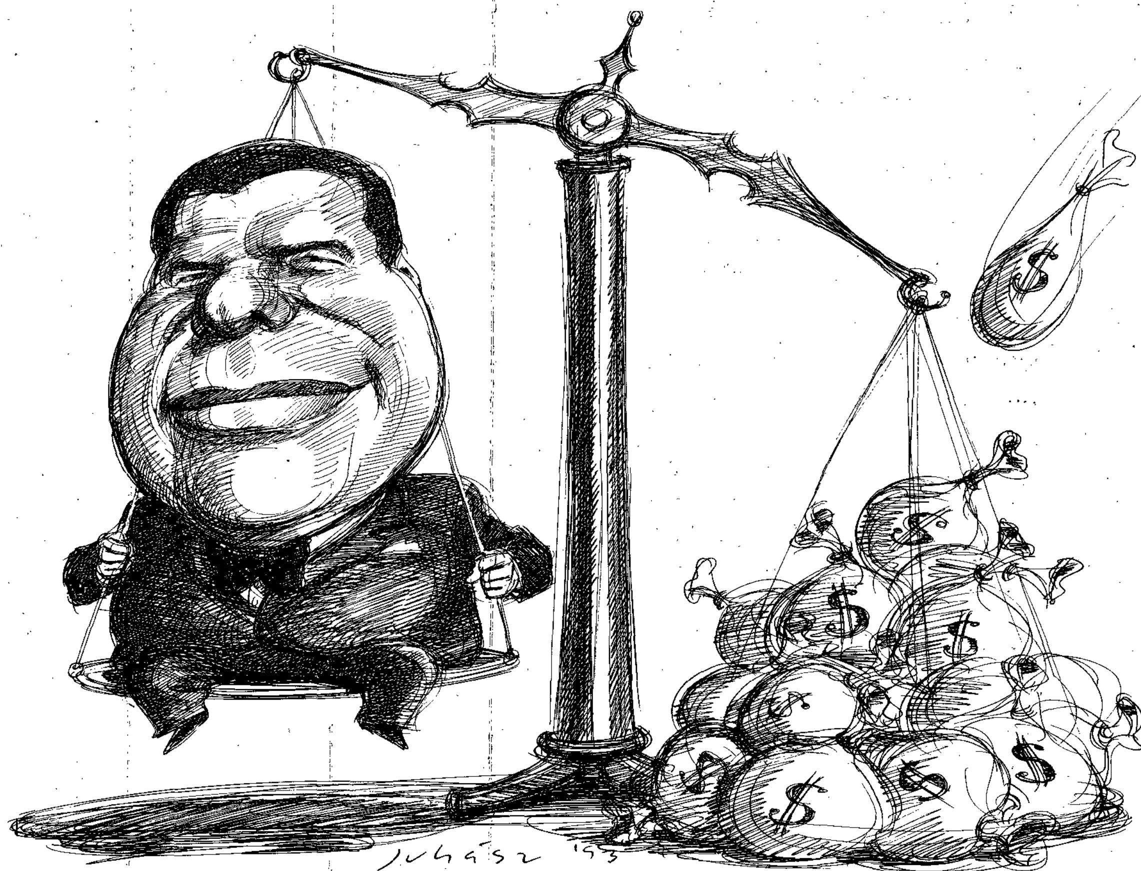
CARLOS MIRO
A CONVICTED INSURANCE SWINDLER AND CON MAN TESTIFIED BEFORE CONGRESS ON THE SUBJECT OF QUESTIONABLE INSURANCE INDUSTRY PRACTICES

ARTHUR L. WILLIAMS
A HIGH SCHOOL-FOOTBALL-COACH-TURNED-LIFE INSURANCE HUCKSTER, MADE HUNDREDS OF MILLIONS OF DOLLARS BY EXHORTING HIS HUNDREDS OF THOUSANDS OF PART-TIME SALESMEN TO "DREAM BIG" AND ADVISE CLIENTS TO "BUY TERM AND INVEST THE DIFFERENCE"

V.J.

THE LIFE INSURANCE COMPANY THAT TILLED THE FIELDS

DURING THE GREAT DEPRESSION, THE METROPOLITAN LIFE INSURANCE COMPANY BECAME THE LARGEST FARMER IN THE COUNTRY DUE TO FORECLOSURES. TO MANAGE THEIR TWO MILLION FARM ACRES THE COMPANY FORMED A "DEPARTMENT OF AGRICULTURE"



"Reliance Group's Chairman, Saul Steinberg, collects his $6 million salary."

Not everyone likes *Emerson, Reid's Insurance Observer.*

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We don't try to report "the news." You can get that lots of places. Besides, by the time something is news it's too late to do much about it anyway.

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- In June of 1989, when others were predicting an imminent upturn in the property-casualty market, we told you it wasn't going to happen for a long time.
- In January of 1990 we said First Executive looked like a goner. A little over a year later it was gone.
- In our March 1991 "Gala Depression Issue" we asked, "Will your insurance company go bust?" and warned about the insurance industry's real estate problems.

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