EMERSON, REID'S

INSURANCE OBSERVER

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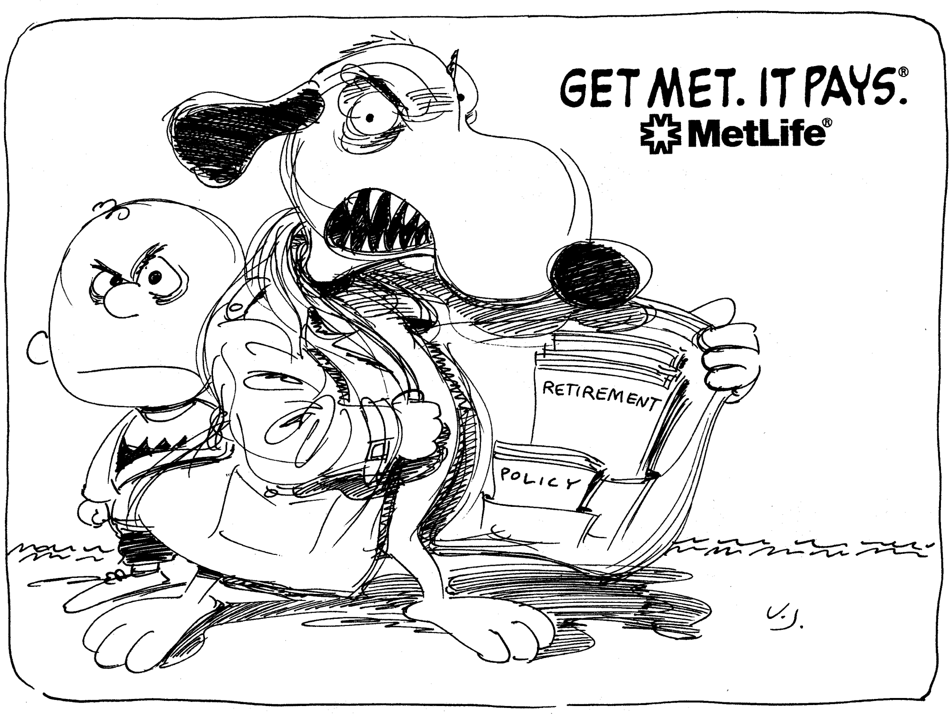
Seems Like Old Times

Been down so long it looks like up

The first American fire insurance company, the Friendly Society for the Mutual Insuring of Houses Against Fire, was formed in Charleston, South Carolina, in 1736, and operated successfully until it was bankrupted four years later when a fire destroyed more than 300 houses in Charleston. The mistake the folks at the Friendly Society made—having inadequate financial resources and an overconcentration of risk—has been repeated many times since then, the most recent example being that of 20th Century Insurance, which accepted $11.83 billion of risk in Los Angeles and Orange County in exchange for $80 million in premiums. The Northridge earthquake left 20th Century with $800 million of claims, considerably more than its $564 million of surplus. That 20th Century is still standing is a testament to the strength and profitability of its auto insurance business.



MetLife, which will pay $20 million in fines because of its deceptive life insurance sales practices, unveils a new advertising campaign.

Most big insurance companies don't accumulate risk the way 20th Century did. Instead, they accumulate risk gradually, across many lines of business, by writing each policy at a premium that's a bit too low, by offering policy terms that are a bit too generous for the premium paid, and by posting reserves that won't quite cover the claims the policy produces. Historically, these bad habits haven't got companies into as much trouble as one might expect; when the situation looked bleak the property/casualty cycle turned up, saving the day.

It's no secret that some of America's large multi-line insurance companies—despite their household names and long histories—don't have business franchises that allow them to earn decent returns on capital (or any return, for that matter). Unfortunately for them, insurance is a commodity and its price over time tends to revert to its cost of production, which consists of claims plus expenses, giving the low-cost producer an edge. Many of the large multi-line companies are plagued by high expense ratios, myriad liabilities from years past, and a culture of mediocrity. These weaknesses make them vulnerable to anything from higher interest rates to a downgrading of their financial ratings.

It's worth pondering whether sick insurance companies will be healed by a turn in the insurance cycle or done in by the lack of one. ■

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The Ultimate Risk

Welcome to Lloyd's, old chap

Until the Lloyd's of London shop on the ground floor of One Lime Street was closed as a cost-saving measure, one could purchase a comprehensive range of goods carrying the famous Lloyd's coat of arms. There was the Lloyd's Tercentenary Commemorative Hallmarked Sterling Silver Coffee Pot ($3,079), Lloyd's gold oval cufflinks crafted by G.M. Betser & Co. ($855), Lloyd's silver inkwell ($522), and 230 other items, ranging from crystal decanters, brandy goblets, and silver serving dishes to blazer buttons, jigsaw puzzles, silk ties, chocolate mints, and a pewter replica of the Lutine Bell. There was even a board game called the *Underwriter*. To the many Names burned by the $10 billion in losses Lloyd's has posted since 1988, these memorabilia must evoke bitter memories, for Lloyd's had a reputation of transacting its affairs on a higher plane—one of "utmost good faith"—epitomized by Cuthbert Heath's legendary telegram after the 1906 San Francisco earthquake: "PAY ALL OUR POLICYHOLDERS IN FULL IRRESPECTIVE OF THE TERMS OF THEIR POLICIES."

Anyone who believes that the folks at Lloyd's, in their Gieves & Hawkes pinstripes, are a cut above the rest will dispense with that notion upon reading Adam Raphael's *Ultimate Risk: The Inside Story of the Lloyd's Catastrophe* (Bantam Press, £16.99). Raphael, who now writes for the *Economist*, is an investigative reporter and former executive editor of the *Observer*. It's rare that a talented writer turns his sights on the insurance industry (another exception is Pulitzer-prize winner Marquis James, who wrote a history of Metropolitan Life), but Raphael has good reason to be familiar with Lloyd's—he's been a Name for the past decade and is now facing serious losses. Unfortunately, his bitterness permeates an otherwise interesting account; the book contains far too many stories of Names who did themselves in as a result of their losses. Even though Lloyd's was famous for its unlimited liability (in the 1930s Hollywood film *Lloyd's of London*, an underwriter says, "Every claim must be paid to the last penny, even if it ruins us all!"), and even though Names had been apprised of their unlimited liability—"Down to your last cufflink"—Raphael argues that most weren't really aware of the risk.

Raphael believes that the Names who joined Lloyd's in the late 1970s and 1980s were suckered in by the lure of steady profits with little risk, and then ripped off through conflicts of interest, fraud, and gross mismanagement. Although there's some truth to this, his broad indictment often goes too far. "The scale of asbestos claims was foreseeable by the late 1970s," he writes incorrectly. "By 1982 it was clear that the market was facing a very serious problem. But little or none of this was disclosed to the thousands of Names who were recruited by commission agents and persuaded to join long-tail syndicates in the mid 1980s."

Raphael thinks that Lloyd's is dishonestly stacked in favor of insiders. He cites a Society of Names' report showing how various Names fared from 1983 to 1990. Based on a hypothetical premium line of £400,000, members of Lloyd's council, managing or members' agents, and underwriters would have made £72,400, £64,000, and £40,800, respectively, whereas external Names would have lost £11,200. External Names outside of England would have fared even worse, losing £35,200.

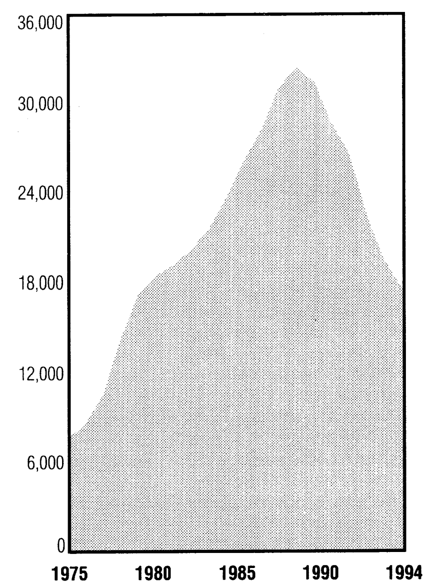
Of course this doesn't prove a conspiracy any more than the fact that partners at Goldman Sachs do far better in the market than the average mutual fund investor proves that the securities market is rigged. Knowledgeable insiders always have an edge on uninformed outsiders.

During Lloyd's fat years, new members flocked to the market, viewing it as an easy way to make money. Not surprisingly, the rapidly expanding syndicates they joined turned out to be the ones with the highest risks and, ultimately, the worst results. In the words of one leading managing agent, "If God had not meant them to be sheared, he wouldn't have made them sheep."

One mechanism that helped set the stage for these newer Names' losses is Lloyd's three-year accounting period. In order to separate the interests of Names on different syndicate years, a syndicate manager calculates profits or losses three years after the end of the underwriting period. The syndicate manager then effects Reinsurance To Close (RITC), which transfers all liabilities, along with appropriate assets, from the prior-year syndicate to the successor-year syndicate. The calculation of the RITC is crucial. If it's too high, the Names on the prior-year

Leaving in Droves

Number of participating Names at Lloyd's



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Lloyds of London

Reserves have risen much faster than surplus (£ billions)

	Reserves	Surplus
1982	£4,647	£2,631
1983	5,223	3,366
1984	7,005	3,977
1985	7,072	4,785
1986	8,902	5,636
1987	8,100	6,833
1988	8,900	7,250
1989	10,700	8,297
1990	11,251	6,665
1991	13,724	6,537
1992	18,348	6,091

syndicate will have paid too much. If it's too low, the Names on the successor-year syndicate could face huge liabilities without adequate reserves.

When future liabilities are too uncertain to determine a fair RITC, a syndicate manager must leave the syndicate's year open. Names on open years generally face large, unquantifiable liabilities and are unable to resign from Lloyd's. (There are currently 314 open syndicate years. At present Lloyd's has 179 active syndicates, down from 401 four years ago.)

It is due in large part to incorrect RITC calculations that so many of Lloyd's newer Names feel cheated. In many of the problem long-tail syndicates, the newer Names assumed liabilities from prior-year syndicates in exchange for assets far too low for the previous years' risks. As a result, the newer Names have borne a disproportionate share of the latent pollution and asbestos liabilities without receiving adequate assets to pay these claims; nor did they have the benefits of Lloyd's profits in earlier years.

Ultimate Risk recounts every sleazy aspect of business at Lloyd's. There was the widespread practice of creating baby syndicates (composed mainly of insiders) to skim off the best business from the bigger syndicates. Such behavior was possible because for most of its years Lloyd's was run like a private club. There was little disclosure and there were virtually no rules prohibiting shameful conflicts of interest. (In fact, when Lloyd's covered up important information and was sued, it denied that it owed its Names any specific duty of care.) Only in 1983, after Lloyd's required working members to disclose their financial interests, was it discovered that Sir Peter Green, Lloyd's chairman, had been funneling reinsurance funds from syndicates under his management to a Cayman Island reinsurer in which he had an interest.

All the usual suspects in Lloyd's assorted debacles are here—Gooda Walker, Feltrim, Merrett—as is Richard Outhwaite who in 1982 made the mistake of reinsuring asbestos and pollution liabilities, resulting in a loss ratio for his 1,600-Name syndicate that could be as high as 2,500%.

It wasn't just unsophisticated Names who got burned at Lloyd's, as is demonstrated by Alexander & Alexander's acquisition of the Lloyd's broker Alexander Howden Group. Howden's principals, it later turned out, had diverted premiums to phony Panamanian reinsurers and set up secret trust funds that were used to funnel payments to a Swiss bank and to buy works of art. Raphael quotes Ian Posgate, himself a ruthless and shady Lloyd's underwriter: "[A&A's chairman Jack Bogardus] was played like a salmon on the Tay... [He] is a provincial and didn't know what he was doing. Mr. Grob [Howden's chairman] is immoral and a crook. It was a natural fit between the two of them."

Lloyd's motto, *Fidentia*, appears on Lloyd's coat of arms. It means "confidence." Indeed. ■

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Clear and Present Danger

A.M. Best's covert rating agenda

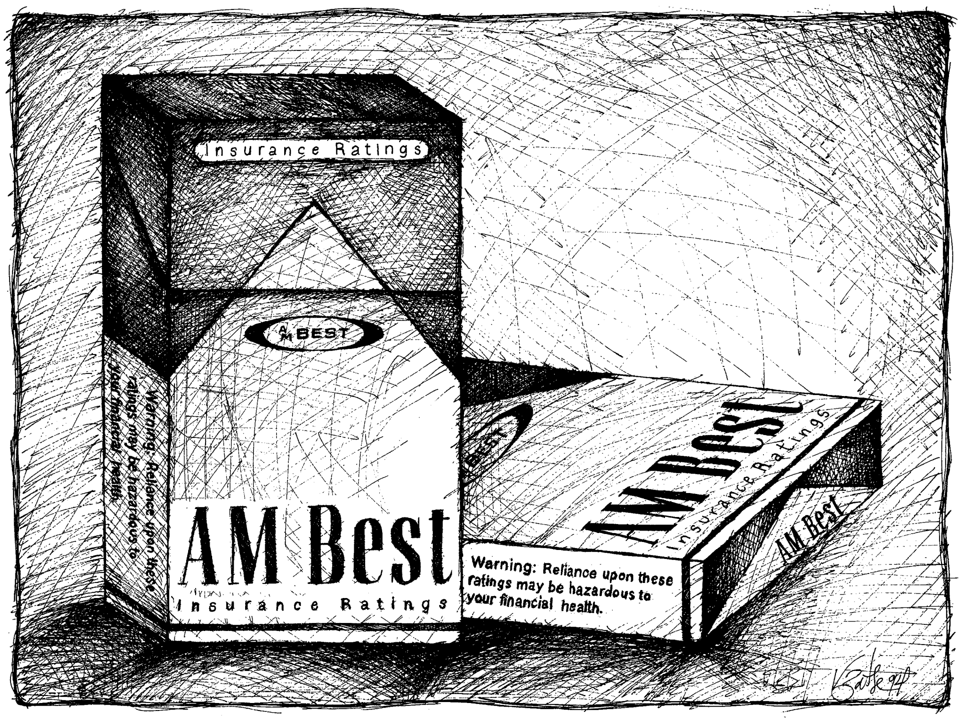
In the past we've called A.M. Best "the Will Rogers of insurance rating agencies" on the grounds that it almost never meets an insurance company it doesn't like. Put simply, Best's ratings aren't especially discerning: 78.2% of property/casualty companies and 65% of life/health companies, respectively, are rated A– or higher. (See graph on page 5.) More distressing is Best's reluctance to downgrade companies below A–, even when such action is obviously appropriate. (An A– rating is considered by many to be the dividing line between good and bad.) Best's reluctance stems from its fear of shaking up the marketplace by announcing that once-strong insurers are now in a weakened state, as well as, we believe, its desire to remain on good terms with the companies it rates.

In its annual *Insurance Reports*, Best devotes about 15,000 words to an explanation and description of its rating system. Left concealed, however, is its corporate philosophy of "managing" the rating process. What this euphemism means is that Best "works with" a company to help it maintain a rating higher than it actually deserves, based on its current financial strength. In certain instances (one of which is described below) Best gives companies much better ratings than they would otherwise have. Best's attitude was neatly summed up by one of its analysts, who told us, "Best does its best to see companies through a difficult period." The result is that the ratings of some companies—it's impossible to say how many, but the number may be large—are significantly inflated.

Best doesn't publicize this covert process or flag insurance companies that have "managed" ratings for the obvious reason: one turns to a rating agency to get an objective, no-punches-pulled assessment.

The recent collapse of A– rated Confederation Life (with $15 billion in assets, it's larger than Mutual Benefit and Executive Life) dramatizes the fallacy of Best's "managed" ratings. Especially revealing—and extremely troubling—are the differences between Best's reports on Confederation prior to its seizure by regulators, and afterwards.

Best's first 1994 report on Confederation, effective April 14, contained six pages of information. Best recounted Confederation's strengths and briefly touched upon the "challenges" and "difficulties" it faced. Even though 50% of Confederation's invested assets were in mortgages or real estate, and 63% of its reserves were the result of annuities, Best affirmed the A– (Excellent) rating, which is given to companies that "have demonstrated excellent overall performance" and have "a strong ability to meet their obligations to policyholders over a long period of time." Nowhere did Best say that Confederation's solvency was contingent upon a proposed alliance (that subsequently fell through) with Great West Life or upon a capital infusion (that never materialized). Yet that was the reality of the situation. Despite Confederation's flimsy financial condition, Best had affirmed its "Excellent" rating, not because it thought Confederation was in good shape (it knew it wasn't), but because it thought that the company would be able to obtain additional capital. But if a company requires a significant capital infusion in order to stay afloat, it stands to reason that until it has received such capital it doesn't deserve an A– rating.



On August 11, 1994, Confederation fell victim to its bad real-estate investments and was seized by regulators in Canada and the United States.

Immediately after Confederation's collapse, Best tried to justify its poor judgment by saying—this is no joke—that Confederation had been in horrible shape for quite a while, and that's why it had been downgraded from A+ to A–. The following is from Best's August update assigning Confederation an E (Under Regulatory Supervision) rating. Certain phrases have been italicized for emphasis:

> [These regulatory actions followed] *a lengthy period of deterioration in the financial condition* of Confederation Life. The progression of this deterioration is reflected in the recent history of the company's Best's Rating. [A+ to A on June 21, 1993. A– on April 14, 1994. B++ on August 4, 1994. Seized on August 11, 1994. E rating on August 12, 1994.]
>
> Although there were many contributing factors in the *adverse trend of operations* at Confederation Life over the last three years, the most dominant was the performance of the company's mortgage portfolio... Given that the company's exposure to [this] asset class was considerably greater at its peak than the industry average... *losses in comparison to its capital were very large.*
>
> *The capital position of Confederation had already been strained... Earnings were also pressured...*
>
> In recognition of these *negative trends*, Confederation sought [to]... obtain additional capital...[which culminated in an agreement with Great West Life for] a $250 million capital infusion, approximately $150 million of additional

capital from asset sales and reinsurance, and a $1 billion liquidity agreement...

In spite of the strength and stability offered by Great West in this planned alliance, A.M. Best lowered its rating by one level, to A–, because of the *continued weakened condition* of the company...

[After the Great West agreement fell through] A.M. Best lowered the rating one level to B++ and immediately placed the new rating under review with negative implications...

If, as Best notes, Confederation had undergone "a lengthy period of deterioration," if its capital was "strained" and earnings "pressured," if its real estate losses were very large "in comparison to its capital" and its "adverse trend of operations" had left it in a "continued weakened condition," why weren't these negatives mentioned in Best's previous reports? More importantly, how could an insurance company in such a state possibly be described by Best as "having a strong ability to meet [its] obligations to policyholders over a long period of time?"

The answer is obvious: Confederation didn't have an ability to meet its obligations and shouldn't have had an A– rating. It probably should have been rated C or C– ("Very vulnerable to unfavorable changes in economic conditions").

The ramifications of Best's Confederation fiasco are enormous. If it is Best's secret policy to deceive its subscribers by inflating the ratings of certain companies in declining financial health, how can subscribers have faith in any of Best's ratings? For Best's ratings to have validity, they must be an honest, accurate, and unflinching assessment of an insurance company's condition at a given time.

Best may argue that sudden downgrades could pull the rug out from under insurance companies by creating a crisis of confidence that could lead to a "run on the bank." While the truth may contribute to or hasten the decline of weak insurance companies, the alternatives—deceit or a cover-up—are unconscionable.

Best has woven a tangled web for itself. Its hidden managed-rating philosophy seems to violate the company's Mission Statement, which is "to perform a constructive and objective role in the insurance industry towards the prevention and detection of insurer insolvency." Best claims that this credo "has been the backbone" of its operating philosophy since 1899.

After ninety-five years in business it's time to get it right. ■

The Harder They Fall

A.M. Best's revised ratings portend a rash of downgradings

In a private dining room at the posh Carlyle Hotel, the president of one of the largest (and highest rated) insurance companies stood before a group of major New York insurance brokers and told them flat-out how to judge an insurance company's financial health.

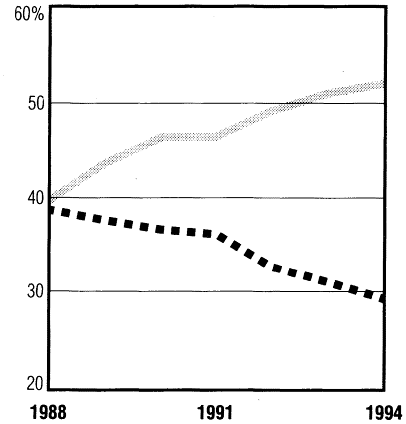
"Best's is nice," he said dismissively, "but Standard & Poor's and Moody's know what they're doing."

Among folks who pay attention to such things, there's a perception that the ratings of Standard & Poor's, Moody's, and Duff & Phelps are more discerning than those of A.M. Best. Whether that's correct is debatable. What isn't debatable is that A.M. Best has been around since 1899 and, for most of those years, has had a virtual lock on the insurance-rating business. Many would argue that Best provides the most comprehensive service, and there's no question that it's the most widely used.

Because of Best's dominant position, subscribers have relied upon it heavily, for the most part accepting its word as gospel. This has often been a mistake, and the failure of a number of large highly-rated carriers (Mission, Executive Life, Mutual Benefit, Confederation) has sullied Best's reputation and raised concerns about the accuracy of its ratings.

A.M. Best's 'Excellent' Adventure

Percentage of Property/Casualty insurance companies rated "Superior" or "Excellent"*



*Companies with a letter rating

Big Companies, Low Ratings

Large property/casualty companies with Best's ratings below 'A'.

	1994	1993
Allstate	A–	A–
Farmers Insurance	A–	A
Liberty Mutual	A–	A–
Continental	A–u	A–
Prudential	A–	A–
Cigna	A–	A–
USF&G	A–	A–
Home Insurance	A–	A–
Reliance	A–	A–
Royal	A–	A–
Metropolitan Group	A–	A–
20th Century	B–	A+
Colonial Penn	B++	NA–5
American Bankers	A–	A–
Arbella Insurance Group	A–	NA–3
Golden Eagle	C++	B-
Penn National	A–	A–
Amerisure	A–	A–

Ranked by net premiums written.

Best hasn't been oblivious to this. It has been lowering companies' ratings for some time. (See chart above.) Since 1988, the number of property/casualty companies receiving A++ and A+ ratings has declined from 38.4% to 29.4% while the number receiving A and A– ratings has increased from 39.8% to 52.1%. Despite the industry's various problems—environmental/asbestos liability-reserve deficiencies, exposure to catastrophes, inadequate profit margins—only three of the hundred largest companies are rated lower than A–.

The previous article discussed Best's covert policy of propping up the ratings of once-strong companies. It appears that Best's new rating designations and definition changes are part of a long-term plan to alter that egregious situation a little. (Best, of course, denies that such a plan exists.) The plan, which is a variation of death by a thousand cuts, would work—Best hopes—by downgrading large, weak companies in a manner that wouldn't cause too much of a stir. Best's dilemma has been to find a way to lower ratings without *really* lowering them. (The "++" modifier was a good example. Since there was no "double-minus," companies could only receive higher ratings.)

There are two parts to Best's solution. First, it tinkered with its rating structure, designating companies "Secure" (B+ and higher) or "Vulnerable" (B and lower). Best downplays the significance of these designations. "This isn't a new concept," it insists. "Internally we've always viewed it this way." (A review of Best's B+ ratings since 1986 doesn't bear this out. As a result of definition changes, the B+ rating was, in effect, upgraded in 1990, downgraded in 1991, and upgraded in 1992 and 1994.)

Second, it has made two important changes in the B++ and B+ definitions. In 1993, these ratings meant that a company had "a strong ability" to meet its obligations although its financial strength "[might] be susceptible" to unfavorable changes in underwriting or economic conditions. Now, although a B++ or B+ company only has a "good ability" to meet its obligations, Best no longer says that it "may be susceptible." Because this category is now considered "secure," insurance companies whose B++ and B+ ratings were affirmed have actually received an upgrade.

Best has even gone so far as to say that the A++ through B+ ratings merely represent "shades of secure financial strength," implying that there's not all that much difference between A++ and B+. According to Best, lower-rated "secure" companies "shouldn't be competitively disadvantaged to a point where they are automatically selected against or excluded from consideration." While it makes little sense to exclude *any* company from consideration "automatically," insurance buyers ought to have a damned good reason for using a lower-rated carrier.

By calling B++ and B+ "secure" and elevating them to the same plane as A++, A+, A, and A–, Best gives itself room to lower the ratings of A– companies, all the while retaining the argument that since the change is only a "shade" of security, it shouldn't cause an adverse reaction in the marketplace. No one should be surprised if Best downgrades numerous A– carriers.

As for the B and B– ratings, which are in the new "vulnerable" category, Best's jiggering has rendered them meaningless. B and B– companies are now defined as "adequate" rather than "good," but last year's "susceptible" has been replaced with the more conditional "may be vulnerable." That, of course, negates the concept of designating B and B– companies "vulnerable." After all, how can a "vulnerable" company be defined as "may be vulnerable."

Changes in Best's Definitions

In 1994, Best made significant changes in the definitions of the B++, B+, B, B-, and D ratings. The 1994 life/health edition of *Best's Insurance Reports* contains an incomplete summary of these changes. (Surprisingly, this summary isn't included in the property/casualty books.)

Ratings	1994	1993
B++ and B+	"Secure...[has] achieved very good overall performance... [has] *a good ability* to meet their obligations to policyholders over a long period of time."	1993: "...[has] achieved very good overall performance... [has] a *strong ability* to meet their obligations to policyholders, *but their financial strength may be susceptible to unfavorable changes in underwriting or economic conditions.*"
B and B–	"Vulnerable...[has] *demonstrated adequate* overall performance... [has] an *adequate ability* to meet their obligations to policyholders, but their financial strength *may be vulnerable* to unfavorable changes in underwriting or economic conditions."	"[Has] *achieved good* overall performance... [has] a *current ability* to meet their obligations to policyholders, but their financial strength *is susceptible* to unfavorable changes in underwriting or economic conditions."
D	"*[Has] demonstrated poor overall performance...[has] a current ability to meet their obligations to policyholders, but their financial strength is extremely vulnerable to unfavorable changes in underwriting or economic conditions.*"	"Below minimum standards."

Down for the Count

Percentage of life insurance companies failing within five and ten years.

Best Rating	Failure Rate: Five Years	Ten Years
A+	0.3%	1.3%
A	1.4	3.0
B+	0.4	3.4
B	1.1	6.4
C+	1.9	8.9
C	1.0	19.6

Based on companies rated from 1978 to 1981.

Source: Lee Slavutkin, M.D., C.P.C., "Life Insurance Company Ratings–How Reliable Is A.M. Best? *Financial and Estate Planning*, August 1991.

Best's contradictory definitions are further proof that it will go to great lengths to avoid saying anything even remotely derogatory about an insurance company. One has to go down to C++ or lower before Best is so bold as to state in its definition that a company is "vulnerable." Only thirty-one property/casualty companies—less than 2% of the total—have ratings this low.

For various reasons (ignorance? negligence? faith?) the property/casualty market hasn't placed much emphasis on relative financial strength and ratings. In a study entitled "The Effects of Best's Rating Changes on Insurance Company Stock Prices," Iowa State University professors Ajai Singh and Mark Power conclude that Best's rating changes are a "non-event in terms of new information conveyed to the market." In other words, the market had already discounted the information and therefore didn't give a hoot about it when it happened.

Our interest in the subject of ratings is not just polemical. Insurers' financial strength should be an important consideration for insurance buyers. (It isn't now.) If, as we hope, the accuracy and honesty of ratings improve in the next few years, the downgrading or, perhaps, insolvency, of some large insurance companies (or the insolvency of some Lloyd's syndicates) may spark a flight to quality by separating the wheat from the chaff. The results may be painful for those insurance buyers, brokers, and companies that get caught off guard.

In the insurance market—unlike the bond market—there's hasn't been a strong correlation between credit quality and price (yield). For a bond, a higher rating—which means less risk—produces a lower interest rate; a lower rating—which means greater risk—produces a higher interest rate. For instance, the yield on *Barron's* high-grade corporate bond index is 8.16%; the intermediate-grade index yields 8.80%. Investors buy lower-rated bonds to earn a higher yield. In doing so they're making a conscious decision to assume greater risk in exchange for greater reward.

Insurance buyers generally don't make conscious decisions to assume credit risk. Although the credit quality of insurance companies declines as one goes down the rating scale, lower-rated property/casualty companies haven't been forced to offer lower prices. (In the life insurance market, top-rated companies tend to have an edge over lower-rated ones, and for products such as GICs, lower-rated companies are generally eliminated from the marketplace.)

In general, it's foolish for insurance buyers to use weak carriers if strong ones offer similar terms. Insurance is bought to transfer risk. For this transfer to occur, an insurance company must be around to pay claims over a long period. Buyers of lower-rated bonds can spread their risk by owning dozens or hundreds of issues, but insurance buyers tend to deal with just a few insurance companies. Since policyholders can lose up to their policy limits (from uncovered claims) in an insurance company failure, such concentration of risk could be especially dangerous.

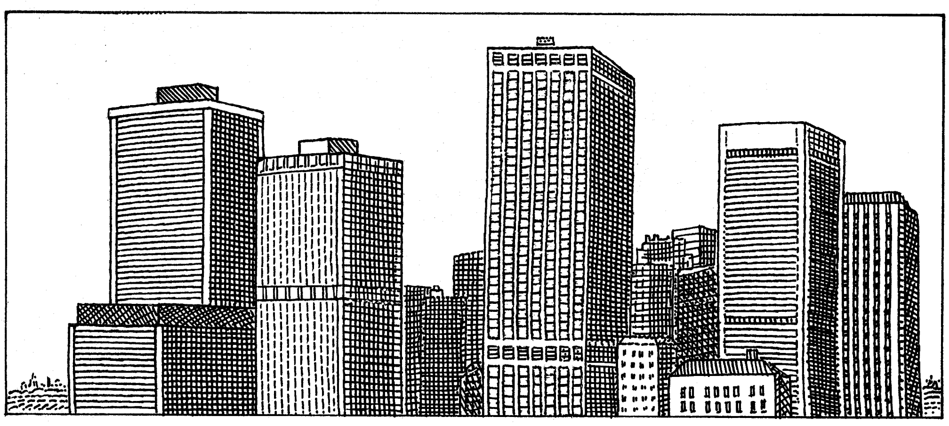
Although the statistics on historical insurance company failures leave something to be desired, they're worth considering. Among life insurance companies rated by Best, 3% of those with an A rating, and 19.6% of those with a C rating, failed within ten years. Of the five largest life insurance failures (Confederation, Executive Life, Mutual Benefit, Monarch, and First Capital), shortly before their demise three were rated A+, one was rated A, and one was rated A–.

In a television roundtable discussion held after the 1991 Mutual Benefit failure, Senator Howard Metzenbaum was asked what a policyholder should do if his insurance company is downgraded. The Ohio senator didn't miss a beat. "Pray," he said.

Those who don't rely on the power of prayer would be wise to start paying serious attention their carriers' financial strength. Now. ■

A Recent History of Best's B+ Rating

Year	Definition	Comments
1986-88	"...[has] achieved *very good* overall performance when *compared to the norms* of the insurance business...*On a relative basis* [has] a *very good ability* to meet their *policyholder and other contractual obligations.*"	
1988-89	"...[has] achieved *very good* overall performance when *compared to the norms* of the insurance business...[Has] a *very good ability* to meet their *policyholder and other contractual obligations.*"	The rating has been upgraded. B+ companies now have a "very good ability to meet their obligations." The caveat, "on a relative basis," has been deleted.
1991	"...[has] achieved *very good* overall performance when *compared to the norms of* the insurance business... [has] a *very good ability* to meet their *policyholder and other contractual obligations*, but their *financial strength is more susceptible* to unfavorable changes in underwriting or economic conditions *than more highly rated companies.*"	Rating downgraded. Best now says that the financial strength of B+ companies "is more susceptible" than that of "more highly rated companies."
1992-93	"...[has] achieved *very good* overall performance when *compared to the standards established by A.M. Best.* [Has] a *strong ability* to meet their *obligations to policyholders*, but their *financial strength may be susceptible* to unfavorable changes in underwriting or economic conditions."	Overall, an upgrade. The "++" modifier added. "Very good overall performance" is now compared with "standards established by A.M. Best" instead of "the norms of the insurance business." B++ and B+ companies now have a "strong ability" rather than a "very good ability" to meet their obligations to policyholders. However, Best no longer comments on a company's ability to meet its "other contractual obligations." (These might include GICs, financial guarantees, etc.) The previous year's caveat, "financial strength is more susceptible," has been toned down to "may be susceptible."
1994	"Secure...[has] achieved very good overall performance... [has] a *good ability to meet their obligations to policyholders over a long period of time.*"	A major upgrade. B++ and B+ now considered "secure." In 1993 Best said that B++ and B+ companies had a "strong ability" to meet their policyholder obligations but that their financial strength "[might] be susceptible." "Susceptible" caveat dropped in 1994. Now, B++ and B+ companies have a "good ability to meet their policyholder obligations over a long period of time." Period.



Policyholders' Surplus–Confederation Life Insurance Company

Seneca Insurance Company

A big-city 'regional' carrier

When Doug Libby became president of Seneca Insurance Company in 1989, he didn't know much about the insurance business. That's understandable, because until that time he'd never worked in the insurance business. In 1983, after practicing law for six years, Libby joined the investment firm L.F. Rothschild, eventually holding the positions of Administrative Managing Director and General Counsel.

L.F. Rothschild fell upon hard times and went out of business five years later. While figuring out what to do next, Libby realized that he'd had a lot of experience with troubled financial institutions. That led him to Odyssey Partners, which owned Seneca. Seneca was clearly troubled; it had lost its shirt writing nonstandard auto insurance through managing general agents, and was overstaffed, undermanaged, and nearly insolvent. One of the first things Libby did was to get Seneca out of the nonstandard auto business. As a result, premiums declined from a high of $75 million in 1986 to $13 million in 1991. The number of employees went from 180 to 60.

Although cutting back stanches the flow of red ink, it doesn't actually *make* you money. To make money, as Seneca is now doing, you have *do* something.

To find out what Seneca was doing, we paid a visit to 111 John Street, one of the older and less desirable buildings in lower New York's insurance district. Seneca's offices are more than drab, they're crummy: the carpeting is worn and the walls could use a coat of paint. On the other hand, the rent is only $8 per square foot—very cheap for New York City.

Doug Libby greeted us. He is thin with wavy blond hair and a narrow face framed by tortoise-shell glasses. Although the dress code at Seneca is casual, on that day he was wearing a suit, tie, and button-down shirt. It took us only a short time to realize that he is not your typical insurance guy: he's sharp, articulate, knowledgeable (he's learned a lot in five years), and outspoken.

Doug Libby

How, we wanted to know, does one turn around a troubled insurance company? And how does one run a small insurance company in New York City?

"When I took over at Seneca I wondered why anyone would give us business," Libby said. "We now operate in two areas: the commodity-oriented mainstreet business (package, general liability, comp, auto) and the quasi excess-and-surplus-lines business. We realized five years ago that with our NA-5 rating we weren't going to write the best drugstore in town. We could write a lot of inner-city stores, though. Our market is the stuff that doesn't fit into the guidelines of other insurance companies." In other words, stuff that's too small, too nasty, or is geographically undesirable.

Libby describes Seneca as a regional carrier for the New York metropolitan area. "A regional carrier is one that better understands a territory and can give agents what they want," he said. "My philosophy is that agents do what they have to do. It's up to the underwriter to *manage* the process."

Seneca practices what Libby calls "value-added underwriting." "We confirm all the major data," he said. Although the average policy premium is less than $5,000, each risk goes through a thorough analysis. Seneca gets a Dun & Bradstreet report, from which it checks the insured's business, number of employees, and annual rental costs. It reviews the fire-rate cards, uses a Cushman & Wakefield service to ascertain square footage, and obtains an A-Plus search that describes a company's loss history. It also inspects every property that it writes.

This diligence has paid off. Four years ago, one in four submissions that Seneca received contained incorrect information. Today it's one in twenty-five. "Our job is too eliminate the ugly 10% of submissions," said Libby. "The big companies have trouble addressing fraud because they're not used to being skeptical."

Seneca's methods are sensible and its insureds are chosen carefully. (Libby owns 5% of the company, so it's his money on the line.) "During the first three years every risk went into a committee," he said. "We've trained our people to have judgment. What I've tried to do is say 'Forget about what the rating system says. What *should* the rate be?' We've made tremendous progress." The combined ratio has declined from 128% in 1989 to 103% in 1993.

"Although we're not necessarily perceived as conservative, what we're doing is making an intelligent risk-reward analysis." Libby cited the example of unoccupied buildings, where the rates are higher than occupied buildings. (The premiums for both are based on square footage.) "The unoccupied one could be a better risk," he said. "There are no tenants to bring claims, no people coming and going, no foot traffic, no deliveries." Writing vacant buildings at a reasonable rate has better risk-reward characteristics, Libby believes, than cutting rates to write the so-called good business.

Seneca also writes—as an admitted carrier—classes of business that are typically associated with the surplus-lines market. These might include restaurants with dance floors, restaurants with more than fifty percent of their revenues from liquor sales, businesses in bankruptcy, and day-care centers. "Success in these markets rests upon the ability to inspect, underwrite, and perform loss control—all the stuff that E&S companies don't do."

Seneca is still a very small company; it wrote only $17 million in premiums last year. With its $30 million in surplus, newly acquired A– Best's rating, licenses in fifty states, and $70 million tax-loss carryforward, it's eager to expand—as long as the reward justifies the risk. ■

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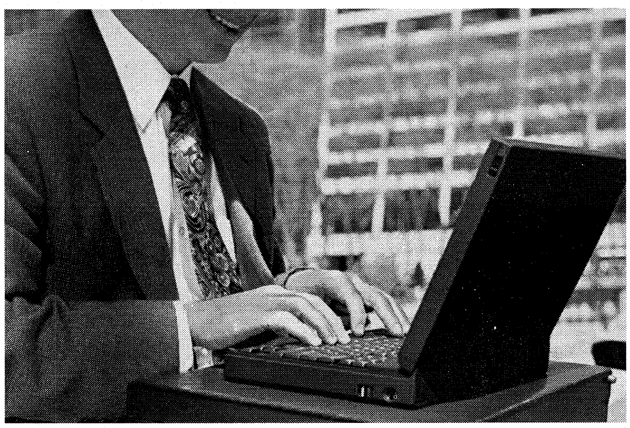

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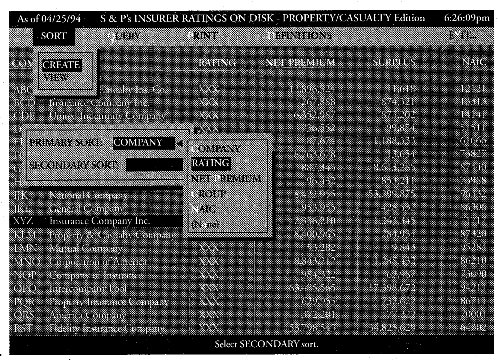

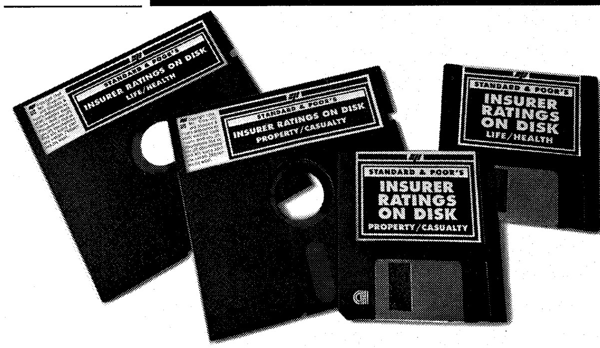

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Other People's Money

Squeeze play at Arista Insurance Company

In a perfect world, the chairman of a publicly held corporation would be a champion of his shareholders' interests. In a less perfect world, the chairman would at least try to strike a fair balance between his interests and those of his shareholders. But the world is far from perfect, as Bernie Kooper, chairman of Arista Investors Corp., well knows.

Arista, a holding company for Arista Insurance Company, specializes in New York State Disability. (Emerson, Reid & Company, the parent company of *Emerson, Reid's Insurance Observer*, is a general agent for many companies, including Arista.) Arista is one of the larger players in its niche, and isn't bad at what it does. Its financial results, however, have been poor. Despite premium volume of $25 million and shareholders' equity of $6.4 million ($2.86 per share), annual earnings have averaged a paltry $280,000 (13¢ per share) over the last five years. Reflecting this sorry performance, the company's stock peaked at its 1987 initial-public-offering price of $4, and has traded between $1¼ and $3 in recent years. (Recent price: $2¼ bid.)

The biggest drag on Arista's results has been its corporate overhead. Chairman Bernie Kooper took home $183,027 last year, and his son, whose services aren't essential, received $109,400.

Kooper owns 25% of Arista's stock, but his Class B shares—which in all other respects are the same as Class A shares—entitle him to elect a majority of the Board. Arista's directors include Kooper, his son, his son-in-law, and his insurance-agency partner.

Since it would be wrong to pay Kooper a salary merely because he's the controlling shareholder, one must assume that the Board's compensation committee (composed of Kooper, his insurance-agency partner, and another director) had good reasons for not only paying him a salary, but for giving him a 20% raise in 1993 and the same bonus as the previous year, when the company's earnings were 50% higher. According to Arista's proxy statement, the 70-year-old Kooper devotes approximately 120 days a year "to the performance of his duties on behalf of the company." Since he isn't an officer of the insurance company, and since the holding company doesn't have any other significant operations, it isn't clear what his "duties" are. The proxy statement says that the company's executive compensation program is designed to "encourage the achievement of...superior corporate performance." That certainly hasn't been accomplished.

The status quo at Arista was disturbed in June 1994, when Old Lyme Holdings, an insurance company, announced that it had acquired 9.84% of Arista's stock at an average price of $2.66 per share. Its 13D filing said that Old Lyme had "been engaged in discussions concerning the acquisition" of Arista, but that the discussions had been terminated because of disagreements over, among other things, "payments to the holder of the Class B shares," namely Bernie Kooper.

Our lawyer sent a letter to Arista's Board of Directors requesting the amount and specific nature of these "payments" as well as the justification for them. (David Schiff, the editor of *Emerson, Reid's Insurance Observer*, is a shareholder of Arista.) Kooper declined to provide this information. "Payments to me were the most minor consideration," he said. "The major obstacle was the terms of the deal." He wouldn't comment on whether he had asked for a higher price for his shares than other shareholders were to receive.

We think that Old Lyme was willing to buy Arista for a combination of cash and stock worth about $3.75 per share—a 60% premium to Arista's stock price. Arista, however, never advised shareholders that it had a suitor, nor did it give shareholders the opportunity to decide for themselves whether this was a good deal.

It's not difficult to see why Kooper might not be inclined to have his cash-cow sold out from under him. At $3.75 per share—which seems like a fair price—he'd end up with about $1.2 million after taxes. The interest on that would be about one-quarter of what his family is getting now.

Old Lyme has asked for, and will probably receive, the approval of the New York Department of Insurance to acquire more of Arista's stock. (It can't go beyond the 10% threshold without that.) Old Lyme may then buy more shares and announce an offer to acquire the company. That would put Arista's board, and Kooper, in a difficult position: if they turn down a good deal they might well be sued.

Whether Old Lyme ultimately gains control of Arista remains to be seen. But for Bernie Kooper and his buddies on Arista's board, one thing seems clear: the heat is on. ■

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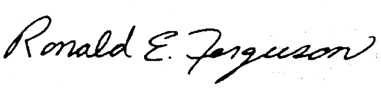
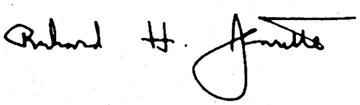
The Insurance Beat

Handwriting On The Wall

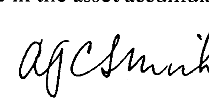
GRAPHOLOGY, the study of handwriting, isn't one of the more respected sciences. It's imprecise, subjective, capricious, and only a step up from fortune-telling and horoscopes—with one exception. The *Schiff hypothesis*, an obscure and little understood proposition, postulates that the signatures of insurance industry chief executives reveal essential truths about their companies. For example:



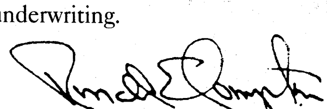
The neat schoolbook letters in General Re chairman Ronald Ferguson's signature underscore the calm that accompanies consistently profitable underwriting and a strong balance sheet.



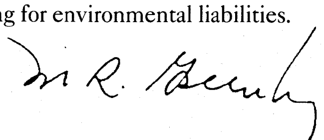
The depressing effect of the Equitable's troubled real estate portfolio is evident in the crunched, abbreviated lettering of Richard Jenrette's John Hancock, although the sweeping flourish of the J in the last name indicates confidence in the asset accumulation business.



Marsh & McLennan's A.J.C. Smith has the quintessential insurance-broker handwriting. The closely spaced, smooth script is typical of middlemen, and the uncrossed T is a hallmark of an aversion to the risks associated with underwriting.



The autograph belonging to Aetna's Ronald E. Compton is psychologically transparent. Although his signature leans sharply to the left, his middle initial—E—is vertical and has a long tail, signifying Aetna's underreserving for environmental liabilities.



Hank Greenberg's inscrutable scawl is an obvious sign of AIG's roots in China.

Yasuda Fire & Marine & Art

IN ADDITION to having an AAA rating from Standard & Poor's, The Yasuda Fire & Marine Insurance Company, Japan's second largest property/casualty insurer, also has an AAA art collection.

According to a report by Barton Biggs, chairman of Morgan Stanley Asset Management, the forty-second floor of Yasuda's Tokyo headquarters houses a number of remarkable works, including Van Gogh's *Sunflowers* (which sold for $39.9 million in 1987), two Renoirs, a Cézanne, and several paintings by Grandma Moses.

So that's where the premiums go.

$2.6 Billion Misunderstanding

AUTO INSURANCE REPORT recently published a study demonstrating that Californians are paying about $150 more per year for their auto insurance because of Proposition 103. Over the last four years the extra cost has totaled $2.6 billion.

These figures were arrived at by comparing the change in California auto insurance profit margins from 1985 to 1988 (pre-Proposition 103) and from 1989 to 1992 (post-Proposition 103) with the national average during the same periods.

Prior to Proposition 103, California's profit margins were two percentage points below the national average. After, they were 3.6 percentage points higher.

What's the explanation for this? A weak economy (which results in fewer miles driven), a higher percentage of middle-aged drivers, and various other factors helped suppress claims during the latter period, increasing auto insurance profitability. California insurers, however, were reluctant to lower their rates to compete for this newly profitable business because they felt that the hostile regulatory environment wouldn't allow them to raise rates if claims were to rise in the future. As a result, profit margins expanded beyond the national average.

Contrast this to Illinois (the largest open-competition state) where auto insurance profit margins remained the same (6.9%) from 1989 to 1992 as they were from 1985 to 1988. Although this is higher than the national average, it is 1.7 percentage points lower than that in California. It seems that Illinois insurers were willing to compete vigorously and accept lower margins, because due to the lack of regulatory constraints rates can be raised quickly and easily if claims increase.

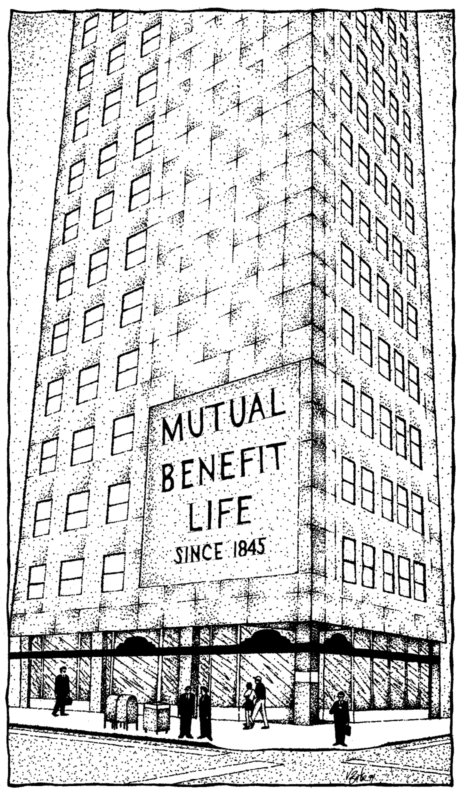
Over longer periods insurance costs closely track claims. The key to reducing rates is reducing claims, not constraining insurers' profits or return on equity. A regulatory environment that doesn't permit adequate profit will, in the long run, drive insurers out of the market.

Laissez-faire, anyone?

Good Housekeeping

AN ARTICLE IN the June issue of *W*—a publication devoted to style and fashion—discussed the enormous difficulties that Gayfryd Steinberg faced after her marriage to Reliance Group's chairman, Saul Steinberg, who gets paid (or, in the opinion of many, overpaid) $6 million a year:

"How, after all," asked the article, "was she going to make a 34-room triplex work as a home for her husband's formidable collection of Old Master paintings as well as for a fairly young family?"



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