EMERSON, REID'S

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So Long, It's Been Good To Know You

The Witches of Oldwick Put a Curse on The Home

In the past, we've criticized A.M. Best, the Oldwick, New Jersey-based rating agency, for three reasons: 1) its ratings weren't discerning—78.2% of all property/casualty companies, and 96% of the hundred largest, are rated A– or better; 2) even when certain large insurance companies faced insolvency from an earthquake or hurricane, it was reluctant to downgrade them to a level that reflected their true risk; 3) it has had a secret policy of concealing negative information from its subscribers, giving "excellent" ratings to companies that it knew were in weak financial condition.

In our October issue we explained why Best's covert rating agenda was intolerable and how its newly revised ratings definitions portended the downgrading of the weaker A– companies. Thus, readers of *Emerson, Reid's Insurance Observer* probably weren't shocked when, on November 7, Best finally took action and downgraded The Home Insurance Company two notches, from A– to B+, its lowest "secure" rating. (Standard & Poor's and Moody's had given The Home lower ratings for some time, but their ratings are not as widely followed.)

The downgrading of The Home is an extraordinary event with enormous implications for the insurance industry as a whole, for insurance companies in declining or weaker financial condition, and, of course, for The Home. It's the beginning, we believe, of an era in the property/casualty insurance business in which financial strength is not taken for granted. (That's already happened, to some extent, in the life insurance and reinsurance industries.) The result may be a two-tiered property/casualty market: larger insurance buyers will shun the lower-rated companies, while individuals and smaller businesses might find them acceptable (or not appreciate the difference).

The downgrading of The Home isn't the result of an isolated event; instead, it's a recognition of the long-term decline of the major multi-line companies. Other major carriers have shared The Home's weakness in the past, but A.M. Best was unwilling to issue them a rating below A–, for a variety of reasons. That, obviously, is no longer the case, and it's likely that more A– companies will soon be downgraded. *Continued*

Conseco's chairman, Stephen Hilbert, couldn't arrange financing to acquire Kemper.

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The Home Insurance Company
Highly concentrated in commercial lines

Line	Gross Premiums ($ millions)	No. of Accounts
Major Casualty[1]	$713	400
Major Property[1]	118	500
Middle Market[2]	688	6,700
Specialty Lines[3]	726	NA
TOTAL	$2,245	

1. Major accounts are large industrial or commercial enterprises that employ a risk manager. In general, major casualty accounts generate more than $1 million in premium, and major property accounts generate more than $100,000.

2. Middle market accounts generally produce between $50,000 and $1,000,000 in annual premium.

3. Specialty Lines include professional liability, excess casualty and umbrella, surplus lines, and D&O.

12/31/93

The question insurance buyers and brokers must now ask is this: is it safe to use a B+ carrier? Although Best says that B+ companies have "achieved very good overall performance," that description clearly doesn't fit The Home. It has historically been underreserved and, despite considerable restructuring, has found profitability elusive. Insurance is bought to transfer risk. For this transfer to occur, an insurance company must be around to pay claims over a long period. An insurance buyer has nothing to gain and much to lose by using weaker carriers when stronger ones are offering similar terms. While it's possible that The Home may rise again, history has demonstrated that it's difficult to turn around large, ailing insurance companies. Betting on such a turnaround, to paraphrase Samuel Johnson's comment on second marriages, may be a triumph of hope over experience.

For The Home Insurance Company, once the largest fire insurer in America, Best's downgrade is cataclysmic. Without an A– rating it will have difficulty attracting new business and retaining existing business. It will become the victim of adverse selection.

The Home is dependent on a small number of brokers. In 1993, its top ten national brokers wrote 56% of its $2.4 billion in premiums, and a quarter of the remaining business was placed by other key brokers. These larger brokers are more likely to move their business or steer it to other carriers than are smaller agents writing Main Street and personal lines business, two markets that The Home isn't in. In recent years it has shifted its focus to large ($1,000,000+ in premium) and medium-sized ($50,000 to $1,000,000 in premium) commercial accounts—just the sort of business that's likely to move because of a weak rating. The Major Accounts unit, for example, which took in $832 million last year, consists of only 900 accounts. These large enterprises employ a risk manager who knows that he might lose his job if he were to place business with an obviously weak insurance company that subsequently fails. Exacerbating the situation is the fact that some brokers won't place coverage with a company rated lower than A– unless they get a signed letter from their client instructing them to do so. (We hear that upon The Home's downgrading some brokers immediately lowered their credit standards to B+ or better.)

In 1993, 56% of The Home's $2.4 billion in premiums were written by its top ten national brokers.

Third parties may also be unwilling to accept The Home's paper. Banks and mortgagees generally insist on A– rated insurance companies, and vendors, additional insureds, and other interested parties will also become sensitized to the subject.

The Home, like most property/casualty insurance companies, isn't prone to a run on most of its assets. At year end 1993 its loss reserves (which aren't subject to demand) accounted for $2.7 billion of its $3.7 billion in liabilities; unearned premiums were $630 million. However, if a significant number of clients decide to go elsewhere, the company's cash flow will turn sharply negative and its expense ratio will soar. In theory, an insurance company could operate in that environment for years, depending upon the length of its liabilities. In practice, the regulators might not allow it.

The Home has adopted a "capital plan" to raise $250 million, but given its financial condition it remains to be seen whether that much—if anything—can be raised. Without more capital and without an A– rating, the company is in deep trouble.

Although hope may triumph over experience, in our opinion The Home is no longer a viable operation. ■

Hold That Rating. Please!

When USF+G was going through the early stages of its restructuring in 1991, A.M. Best lowered the company's rating from A– to B+. Norman Blake, the dynamic CEO who'd just come over from Heller International, felt that this downgrade would virtually put him out of business.

Before the rating was released to the public, Blake went back to Best and convinced it to hold off for ninety days, during which time he'd raise the capital necessary to retain the A– rating.

Best agreed, and Blake raised $320 million from the sale of preferred stock, thus keeping his company's A– rating.

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There's No Place Like Home

The rise and fall of The Home Insurance Company

In April 1853, when The Home Insurance Company was formed in the directors' room of the Continental Bank in New York City, the insurance industry was in a nascent stage. There were less than 250 property insurance companies in America, many of them small local mutuals. The industry's total premium volume that year was $15.5 million and policyholders' surplus stood at $42.6 million.

Starting an insurance company to write business on a national scale through local agents, as The Home intended to do, was, in the words of one city underwriter, "a wild and reckless experiment." The previous year, New York's comptroller had cautioned mutual companies and stock companies about writing business outside their county and their state, respectively.

Nevertheless, The Home, which, with $500,000, was capitalized at twice the level of any other New York company, entered the business and, within eighteen months, had signed up 140 agents. After a couple of difficult years the company grew steadily until October 8, 1871, when the great Chicago Fire cost it $2.5 million—wiping out all but $128,000 of its surplus. The Home was recapitalized by a $1.5-million shareholder assessment.

By 1902, its fiftieth anniversary, The Home had become the largest fire insurance company in the country. Annual premiums were $7.3 million and shareholders' equity was $9.5 million. One measure of the company's success was the $13 million in dividend payments it had distributed to shareholders over the years.

The Home's growth continued, handily outpacing that of the U.S. economy. By 1928, surplus stood at $76 million, premiums at $49 million, and total assets at $128 million.

During the 1920s it was common for fire insurance companies to invest heavily in common stocks, and The Home was no exception. But, with the 1929 stock market crash, the onset of the Depression, and the continuing decline in stocks and bonds, The Home's portfolio was devastated. Had it been forced to mark its investments to market at year-end 1932, it would have been close to insolvency. Other insurers were in a similar bind, but the National Convention of Insurance Commissioners came to the industry's rescue by passing a resolution permitting insurance companies to value their securities at June 30, 1931, prices, which were significantly higher. (Similar regulatory initiatives had been taken in 1907 and in 1917–1921.) The Home's own stock fared poorly during this period, falling from a high of $77½ in 1929 to a low of $6⅞ in 1932. It was a difficult time, although the insurance industry as a whole fared far better than the general economy. The Home's premiums declined 18% between 1929 and 1932, and underwriting profits were replaced by losses.

The insurance business of sixty years ago bears only scant resemblance to that of today. Casualty insurance was virtually nonexistent;77% percent of The Home's premiums, for example, resulted from fire insurance, with automobile, tornado, and inland marine constituting the other important lines. The stronger insurance companies' balance sheets were impressive for their conservatism. The Home's $32 million in surplus far exceeded its $6 million in loss reserves. (By 1993, when casualty insurance accounted for 90% of The Home's premiums, the company's $900 million of surplus was dwarfed by $3.3 billion in loss reserves.)

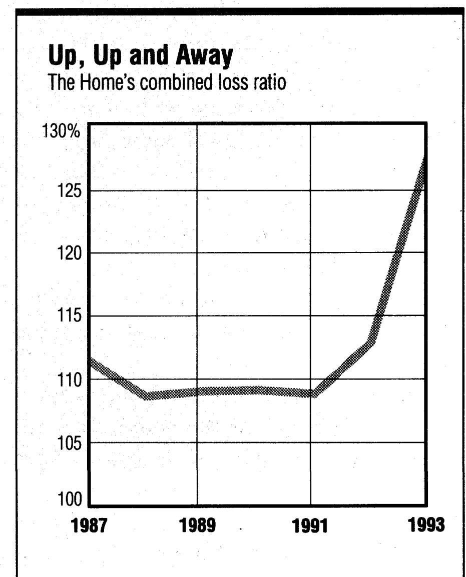
The country, of course, pulled out of the Depression, and so did The Home. By 1962 its surplus had grown to $310 million and its 50,000 producers were generating $300 million in annual premiums (still almost entirely from property coverages). Over the preceding five years its combined ratio had averaged 99.7%, and it was rated A+ by A.M. Best, which commented that it was "one of the most prominent insurance carriers in the world...The directors are men of proven ability and high reputation... [The company] is in an unusually strong financial position."

In 1968 The Home was acquired by City Investing, a large conglomerate. (Saul Steinberg's Leasco acquired Reliance Insurance Company that same year, and ITT acquired the Hartford Insurance Company two years later.) This would mark the beginning of The Home's long decline. Peter Huang, a tyrannical boss with a legendary temper and a disdain for the insurance business, was later brought over from City Investing's manufacturing operations to run The Home.

By the late 1970s The Home was seriously underreserved, and it was rumored to be both on the verge of insolvency and up for sale. The company was also in the midst of a grand change in underwriting policy. In an attempt to model itself after AIG, it expanded into the gross-lines underwriting of large risks, which would then be heavily reinsured. (Casualty lines now accounted for half the premium volume.) A.M. Best, damning The Home with faint praise, lowered its rating to Contingent A.

By 1985 The Home was reeling. It was definitely up for sale, but there were no buyers, prompting *Institutional Investor* to call it "the insurance company nobody wants."

Unable to find a buyer for it, City Investing spun off The Home, renaming it AmBase. In a series of ill-fated moves, it took on debt, attempted to turn itself into a financial supermarket by acquir-



ing a brokerage firm and a savings and loan, and invested heavily in junk bonds. The business floundered, and the company's stock collapsed from a high of $31½ to next to nothing. (That didn't prevent the chairman, George Scharffenberger, and the president, Marshall Manley, from receiving extravagant salaries and perks.)

Finally, a buyer emerged from overseas—Trygg-Hansa SPP, Scandinavia's largest insurance company—which, when the dust settled, had shelled out $663 million for the dubious distinction of owning The Home. (Trygg-Hansa also lent Home Holdings—the company's new moniker—$170 million.)

In December 1993, in a stroke of good timing, Home Holdings raised $128 million from a public offering of stock at $17 per share. (As the stock is now $3⅛, Trygg-Hansa has lost, on paper, at least $600 million.) The Home also managed to raise $280 million from the issuance of intermediate-term senior notes carrying interest rates of 7% and 7⅞%.

Home Holdings' bonds are trading at distressed prices. The indicated yield-to-maturity is 21%, implying that the company will default.

These deals were a hard sell, and their prospectuses mention a plethora of "risk factors": the cyclicality of the property/casualty insurance industry; "the inherent uncertainties of estimating loss reserves"; The Home's "history of underwriting losses and escalation of loss ratios"; leverage, dividend restrictions, and the holding company structure; insurance regulation; catastrophes; reinsurance considerations; competition; and so forth.

One risk factor that seems to have been overlooked was the company's vulnerability to a rating downgrade from A.M. Best. Indeed, when Reliance Group, which was in a similar bind, issued $650 million of debt the previous month, its prospectus carried the following caveat: "A downgrade in the Best rating below A– could adversely affect the competitive position of the Reliance Property and Casualty Companies."

Why The Home, its underwriters, and their lawyers left out wording of this sort is a good question. Given The Home's disastrous results—it has lost $121 million in the first nine months of 1994—and the litigious nature of our society, it seems likely that lawsuits will be filed. (Who knows, The Home, a large writer of lawyers professional E&O, may even be on the risk.)

That things are now going terribly for The Home is undeniable. When it announced its third quarter loss on November 7 and a concomitant decline in shareholders' equity, the company also said that it planned to raise up to $250 million "through any combination of a public offering of debt and/or equity securities, a private placement of debt and/or equity securities, and/or a credit facility from a bank." Trygg-Hansa has offered to convert its outstanding $170-million loan into equity should that be necessary. According to the company's press release, this action "is a sign of Trygg-Hansa's long-term commitment to Home Holdings."

That's debatable. From the look of things, it seems Trygg-Hansa didn't want to throw more money into The Home, or wasn't able to. Why, after all, would it let the company's ratings be lowered to a level that could jeopardize its business?

We wonder whether anyone will choose to put equity into Home Holdings given its current situation. The company is quite leveraged, and the outstanding senior notes have a lien on the capital stock of The Home Insurance Company. Were someone to pump $250 million into Home Holdings there might be a "change of control" which would trigger an "event of default" under the senior notes' indenture and require that the notes be redeemed at 101% of par. The notes are currently quoted at the severely distressed price of $40 bid – $60 offered, giving them an indicated current yield of 17.25% and a yield-to-maturity of 21.6%. These yields imply that the notes will either default or be restructured. (When Standard & Poor's and Moody's recently downgraded the notes to the level of "junk": BB– and Ba2, respectively, a clause in their indenture mandated an 87.5 basis-point increase in the interest rate that the company must pay.)

The Home Insurance Company

Big decline in Major Casualty premiums: A flight to quality?

Net written premium ($ millions)	Third Quarter 1994	Third Quarter 1993	Nine Months 1994	Nine Months 1993
Major Casualty	$106	161	409	540
Middle Market Casualty	118	128	346	417
Commercial property	30	20	59	69
Specialty Lines	132	117	395	349
TOTAL	$386	426	1,209	1,375

	1994[1]	1993	1992	1991	1990
Net Premiums ($ millions)	$1,250	1,882	1,628	1,705	2,022
Underwriting loss ($ millions)	280	540	211	191	215
Employees	3,100	3,500	4,100	4,400	4,700

1. Through 9/30/94

Home Holdings may face a moment of truth on December 15, when an $11.6 million interest payment is due to the noteholders. In order to pay the interest on its debt, Home Holdings relies upon dividends from The Home Insurance Company. Given The Home's need for capital, it's questionable whether it will be able to pay dividends. Under New Hampshire law (where the company is domiciled) an insurance company must notify the insurance commissioner fifteen days prior to the payment of a dividend. If the commissioner concludes that, following the payment of that dividend, an insurance company would be inadequately capitalized, it may forbid the payment of the dividend.

Although The Home had $706 million of statutory surplus at September 30, as a result of rising interest rates, its bond portfolio was $207 million underwater, and the specter of future loss-reserve additions looms.

Obviously, the Home's management is not saying that the company is in dire straits, and it strongly disagreed with Best's rating downgrade. Nonetheless, Lars Goran-Nilsson, the company's president, doesn't paint a pretty picture of the future. "If you believe, in this market, that you're not in the middle of a restructuring, then you should prepare for one," he advised at a recent Wall Street gathering.

"If I sound a little cynical," he added, "that's because I am." ■

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ABC	Casualty Ins. Co.	XXX	12,896,324	11,618	12121
BCD	Insurance Company Inc.	XXX	267,888	874,321	13313
CDE	United Indemnity Company	XXX	6,352,987	873,202	14141
D		XXX	736,552	99,884	51511
E			87,674	1,188,333	61666
F			8,763,678	13,654	73827
G			887,345	8,643,285	87440
H			96,432	853,211	73988
HK	National Company		8,422,955	53,299,875	96532
JKL	General Company		953,955	428,532	86306
XYZ	Insurance Company Inc.		2,336,210	1,253,345	71717
KLM	Property & Casualty Company		8,400,965	284,934	87320
LMN	Mutual Company	XXX	53,282	9,843	95284
MNO	Corporation of America	XXX	8,843,212	1,288,432	86210
NOP	Company of Insurance	XXX	984,322	62,987	73090
OPQ	Intercompany Pool	XXX	63,485,565	17,398,672	94211
PQR	Property Insurance Company	XXX	629,955	732,622	86711
QRS	America Company	XXX	372,201	77,222	70001
RST	Fidelity Insurance Company	XXX	53,798,543	34,825,629	64302

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C. Burton Kellogg Speaking

The A.M. Best to You Each Morning

On January 13, 1993, at about 9:30 in the morning, C. Burton Kellogg II, A. M. Best's senior vice president in charge of property/casualty and life/health ratings (and, with his family, owner of 20% of the company), was deposed in conjunction with two related lawsuits: Clarence Kayes v. Pacific Lumber Company, and Lynn Martin, Secretary of the United States Department of Labor, v. Pacific Lumber, MAXXAM, et al.

Pacific Lumber, the owner of one of the largest private tracts of California redwood forests, had been taken over by MAXXAM on February 26, 1986, in a deal financed with junk bonds issued by Drexel Burnham. The largest purchaser of these bonds was Executive Life.

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On March 31, 1986, Pacific Lumber's overfunded pension plan was terminated, and the vested benefits were replaced by an annuity issued by Executive Life, which had been the low bidder. Executive Life's subsequent insolvency, and the lack of collateral for Pacific Lumber's retirees, was the genesis of the lawsuits.

Although A.M. Best isn't a party to the lawsuit, it was subpoenaed to testify about the significance of the A+ rating (then its highest) that it had given Executive Life. Before the deposition began, Best's counsel stated that he might instruct Kellogg not to answer questions dealing with trade secrets and those covered by the journalistic privilege of confidentiality.

Throughout the deposition Kellogg, who has a B.A. in economics from Dartmouth and a masters in finance from Columbia, displayed his knowledge by providing thoughtful, reasoned answers. Many of the questions he was asked showed a lack of understanding of the insurance business, and at times it was clear that Kellogg was fed up with the whole process.

The following excerpts are taken from the deposition:

PLAINTIFFS' LAWYER: What is your current position with A.M. Best?

KELLOGG: Group vice president. I have responsibility for overseeing the property/casualty, health, and international publishing of A.M. Best.

I started out in the life/health department in July of '58. I was subsequently made director of the life department for approximately twenty-five years. I then became senior vice-president.

LAWYER: How often did you actually participate in the review of a specific rating?

KELLOGG: I don't think I can answer that question today.

LAWYER: Was it rare?

KELLOGG: Well, you have to realize that we are dealing with some 1,500 life companies and 2,000 property/casualty companies.

LAWYER: Did you participate in any particular review of Executive Life in 1986?

KELLOGG: I probably did.

LAWYER: Do you have an actual recollection of doing so?

KELLOGG: I don't recall this specific assignment of that rating, but I assume I was probably involved in it.

LAWYER: Why do you assume you were probably involved in it?

KELLOGG: Because over a period of time you have a number of ratings that are subject to review and this would be one of the ones. It was a rapidly growing company at the time.

The Rating Process

LAWYER: What is meant by a "quantitative" review? [Editor's note: Best makes a "quantitative" and "qualitative" evaluation of insurance companies.]

KELLOGG: We get a convention statement which is filed by the insurer with the various insurance departments where it is licensed. This document will run upwards of eighty pages, although it may run closer to 200 in some instances. We use that as a document from which to collect financial data.

Then we will run a number of ratio tests which we think are relevant to measuring the performance of an insurance company. We look at, primarily, the areas of profitability, leverage, and liquidity and compare them to the norms established by A.M. Best Company. These norms are based upon our evaluation of the actual performance of the life/health industry over a period of time.

We [also] have a questionnaire which elicits information from companies about material that is not covered in detail in the convention statement. We would receive a stockholders' report if the company is a stock company; we would receive responses to questions that we have written company officials explaining variations within their convention statement that may look a little out of line of what you would normally expect. Obviously, we receive news releases from the companies as to their progress during the year, and we also receive quarterly statements.

LAWYER: Did Best perform any tests of underlying company documents to determine if the convention blank had been correctly filled out?

KELLOGG: We have computerized the collection of our data and we run a computerized cross-check system. We do not audit the statements. We depend upon the insurance departments and their examination process and/or the public auditors, and we state within our books that we do not audit the statements.

We hold meetings with top management, or they make presentations [to us] as to where they have been and, in many instances, future plans.

[Editor's note: Kellogg also said that Best reviews NAIC reports, subscribes to trade publications, and monitors various newspapers: "Normally national newspapers as opposed to local newspapers."]

LAWYER: Could you describe how a rating would be developed?

KELLOGG: Just about each year we send out a letter to the various insurance companies—health, life, or property/casualty—asking for their annual statements, plus our questionnaire. We solicit comments as to any significant events that happened during the year that might affect the analysis of their data, or any specific management changes that happened during the year, or any changes in direction.

We then get the annual statement in and put it into the computer system and go through and validate the data. We have a number of worksheets that we print out, which calculate ratios. Various analytical people may sit down and

study the worksheets and determine whether the company is progressing positively or negatively.

In most instances, we have a rating from the prior year and we have three decisions: do we move it up, do we move it down, or do we leave it where it was last year?

[Then] the report is prepared. The financials are added to the report. Five-year tables are updated. We do our analytical work and a recommendation is prepared as to the rating, and is submitted to the head of the department.

Operating comments are written during the period—we briefly describe what happened during the year.

In other words, the report is prepared as part of the analysis system. You don't do the analysis and then the report. It is kind of an ongoing process.

We [then] send a galley [of the report] to the company for comment.

LAWYER: If a company disagreed with the proposed rating were they given an opportunity to come in and try to persuade A.M. Best that a different rating should be assigned?

KELLOGG: I would say that a company has an opportunity to come and review the rating.

LAWYER: And who would that review be with at A.M. Best?

KELLOGG: Generally either the analyst involved or the head of the department. It could be any one of a number of people.

LAWYER: Did an insurance company's ability to administer its [book of business] have a part in the rating process?

KELLOGG: We would assume that the company was able to administer its book of business.

LAWYER: You didn't do any independent checking of that?

KELLOGG: No. We are not auditors.

LAWYER: [Did you] go behind the actuarial assumptions [made in setting an insurance companies liabilities]?

KELLOGG: No. The actuarial protection is one that has disciplines and signs pledges—I guess [those are] the words—that they do their work independently and truthfully. We depend on that just as we would depend on an auditor's opinion.

LAWYER: In 1986, did Best view group annuities as inherently or in any way riskier than individual life policies?

KELLOGG: I think that is getting into our trade secrets.

LAWYER: In order to evaluate an insurance company's financial strength, did A.M. Best make any estimates as to the company's future earnings?

KELLOGG: No.

LAWYER: If a company's ability to keep its promises depends in part on its future earnings, how could Best evaluate that ability without examining or making assumptions about how much money the company was going to earn in the future?

KELLOGG: As I stated previously, I don't believe it is a numbers exercise of projecting "x" number of investment dollars. It is more an understanding, and this is where the qualitative comes in, as to whether a company has a realistic interest assumption and whether it has a realistic return.

Reinsurance

LAWYER: In looking at a life insurer's reinsurance arrangements, did you take into account who the reinsurers were?

KELLOGG: That would be reviewed within the annual convention statement.

LAWYER: How do you obtain information about the financial qualifications of the reinsurers?

KELLOGG: We would look at the A.M. Best rating.

LAWYER: Do you look at the terms of the reinsurance treaties?

KELLOGG: We do not read all reinsurance treaties. We rely on the fact that the treaties are approved by insurance departments. In other words, it would be part of the examination. Again, we are not auditors. Part of the audit function would be to determine that true reinsurance existed. In other words, the basis of our analysis is based on the NAIC statement sworn to by the officers of the company and the examination process by the state.

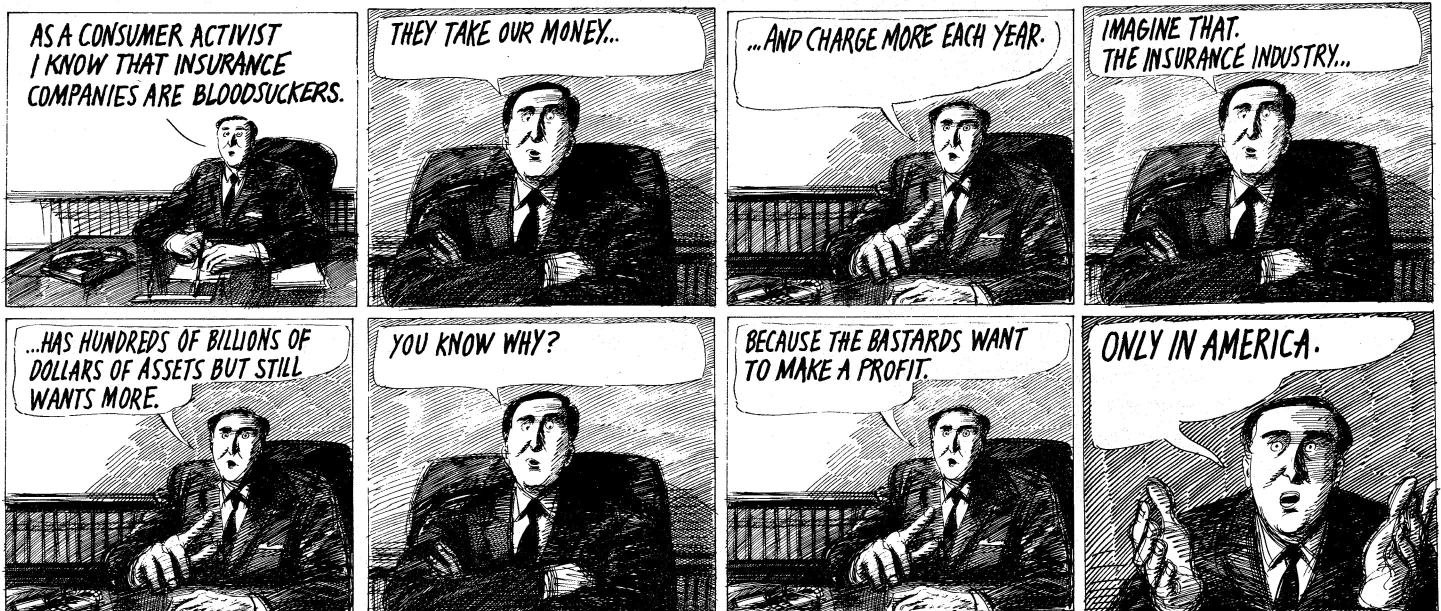
LAWYER: In what way did A.M. Best evaluate the amount and soundness of a particular life insurance reinsurance arrangement? What type of information did Best ask [for]?

KELLOGG: In general, what their maximum net retention was, who their reinsurers were, [and] did they have any special treaties in place.

Best's Analysts

LAWYER: What were the qualifications or training of the analysts who prepared the ratings of life insurers in 1986?

Continued



KELLOGG: They have a number of disciplines. Some worked in the financial departments of insurers, some have worked for us for many years. Normally they would be people that have college degrees with majors in accounting and/or finance. They were typical financial analysts, I guess.

LAWYER: Did Best have any people with actuarial backgrounds on its staff—the staff that was involved in the rating process?

KELLOGG: Not in life insurance, no.

LAWYER: Did you consider actuarial expertise necessary in the life insurance rating process?

KELLOGG: No. Actuarial expertise tends to be a formula-driven exercise. We have had actuaries. We have not found them very helpful in the analytical process. In my tenure as head of the life insurance [department] I had two actuaries and I dismissed each one after several years, as they were not making what I considered a good contribution to our information or rating system.

Best's Ratings

LAWYER: Are there specific gradations or degrees of difference between each of the ratings, and are they the same? For example, is the difference between A+ and A the same as the difference between any other two touching categories?

KELLOGG: I'm not sure there is an answer to your question, because no rating is based on a single factor—it is a combination of factors. To say that there is a specific difference between this—I can state that not all A's are equal for the same reason, because every company that you rate or look at might have a different mix of business, a different mix of assets, different characteristics.

LAWYER: But, on balance, two A's would be the same?

KELLOGG: Two A's are A's, but they are not all—there are high A's and low A's. [Editor's note: This is perhaps the most surprising comment in the entire deposition, but the plaintiffs' lawyers didn't press the issue. One would think that companies with the same rating would have the same financial strength. If, indeed, there are "high A's and low A's," shouldn't Best make this distinction clear to it subscribers? Are there also high A–'s and low A–'s, and so on?]

LAWYER: *Best's Insurance Reports* is intended to set forth Best's opinion as to the financial strength of a life insurance company, correct?

KELLOGG: I have a problem with the way that question is phrased. I believe the rating is the opinion. The report is part of an overall information gathering. The report does contain comments, so that probably alludes to the financial strength of a company, also.

Insurance Company Investments

LAWYER: Were you aware in 1986 that Executive Life had in its investment portfolio a number of what are commonly referred to as junk bonds?

KELLOGG: Were they referred to as junk bonds in 1986?

LAWYER: There you got me. I think officially they were called high-yield, high risk bonds, and were sometimes either low-rated or unrated.

KELLOGG: We were aware that they had high-yield bonds.

LAWYER: Did you, in the course of your rating, examine the level of risk associated with those high-yield bonds?

KELLOGG: How do you measure risk?

LAWYER: I think my question, Mr. Kellogg, is how you measured risk?

KELLOGG: I think it is an indeterminate characteristic probably.

LAWYER: Was it something that you looked at?

KELLOGG: We looked at it, yes.

LAWYER: Did you look at the percentage of Executive Life's overall investment portfolio which was represented by high-yield bonds?

KELLOGG: I believe we would have.

LAWYER: The riskier the investment, the higher the interest rate required to offset that risk. [Is that correct?]

KELLOGG: Economics I, yes.

LAWYER: Did A.M. Best look at the degree of risk associated with a life insurer's portfolio of assets [in 1986]?

KELLOGG: We received a breakdown on the bonds portfolio by the major rating agencies.

LAWYER: And did you look at those ratings and make an assessment as to the level of risk in the overall portfolio?

KELLOGG: I believe that would be called the quality, not the level of risk necessarily.

LAWYER: Are there other things that enter into quality or does level of risk really equate with quality?

KELLOGG: I believe the two are probably close to being synonymous.

LAWYER: But diversification is also an aspect of quality?

KELLOGG: Diversification is an aspect of risk, probably not quality.

LAWYER: Is there any analysis done of the likelihood that a particular [insurance company] investment will continue to perform?

KELLOGG: That is a difficult thing to [do]. That is a prediction. We relied upon the ratings of the Standard & Poor's and Moody's organizations [in analyzing an insurance company's investment portfolio].

LAWYER: Did Best audit the information that [insurance companies] provided about [these] ratings?

KELLOGG: No.

Subscribers

LAWYER: With respect to *Best's Insurance Reports*, the annual publication of all the ratings, was there a specific target audience for that publication?

KELLOGG: We have a number of subscribers. They can be policyholders, they can be government, both federal and municipal, they can be purchasers of insurance, i.e., the Exxons of this world. They can be insurance agents and/or brokers. They could be college professors.

LAWYER: You are perfectly happy if anybody buys it?

KELLOGG: Oh, yes—particularly lawyers. ■

The complete 206-page transcript, which makes an excellent Christmas stocking stuffer, is available for $150 from Emerson, Reid's Insurance Observer.

Dazed and Confused

According to the National Institute on Drug Abuse, 22% of employees in the construction industry use drugs, and 11% of professional employees use drugs in the workplace.

According to *Safe Workplace*, however, stress and fatigue contribute to ten times as many accidents as drug and alcohol use. Edward B. Furey, Jr. of the National Council on Compensation Insurance writes that "employers, doctors, and public health leaders [should] place more emphasis on the importance of sleep in maintaining overall health and workplace safety."

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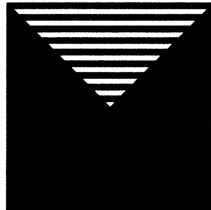

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Auto Insurance Report

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Vol. 1 #15 **Feb. 7, 1994**

Inside

Financial Disclosure Statements have been filed on both sides of the California pay-at-the-pump battle, revealing the scope of spending and where the money came from. **Page 3**

Best Commercial Markets Over Time: Ranking of states by average profit margins since 1985. **Page 7**

Commercial Auto Profits 1992-1985. Page 6

The Grapevine

An opportunity for non-standard writers may be developing in **Mississippi**. The **House of Representatives** has passed legislation strengthening the enforcement of the state's motor vehicle responsibility laws. **H.1095,** sponsored by **Rep. Ann Stevens** and others, hits drivers with a $1,000 fine, in addition to license suspension, if they are involved in an accident and fail to show financial responsibility either through a bond, a certificate of deposit, or insurance. The fine can be lowered to just $100 if the driver purchases insurance. A spokesperson for Rep. Stevens said it is expected the **Senate** will not go along with the bill as currently drafted, and the legislation will wind up in a conference committee. AIR

Auto Insurance Continues To Stay Outside Clinton Health Care Plan

When the Clinton health plan was just a rumor last fall, it seemed the health insurance portion of auto insurance would escape merger into a universal health system. Now, after months of battling and enough studies to fill the Library of Congress, it appears that original position will stand, and auto insurers will get to keep their slice of the business. (AIR, 10/25/93, P1)

Further, there are side benefits to the implementation of the Clinton plan that could save auto insurers billions of dollars.

Now all insurers have do to is to make this scenario comes true, and that will require continued battling.

Auto insurers are advancing many arguments for keeping auto insurance separate. Some worry about insolvencies, others about escalating law suits, others about

Please see CLINTON on Page 2

Illinois: Favorite Example For Light Regs, Heavy Competition

Ask auto insurers what they like best about the **Illinois** market, and you almost always hear "open, competitive environment." Ask the insurance department the same question, and you hear the same answer: "open, competitive environment." When regulator and regulated are singing from the same page, you usually get good news. In this case, an almost total lack of regulatory intervention in rate setting (and a population that sues less than many other large states) has created a fiercely competitive environment.

Here's the good news:

• Premium rates are low for consumers, ranking 22nd in the nation despite the presence of a giant urban center, Chicago. Those rates look especially good to a state with average income ranking around 9th in the country. Of the top 10 states in total premiums, only Ohio has lower

Please see ILLINOIS on Page 5

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The Insurance Beat

Greetings from Orlando

EACH YEAR the Independant Insurance Agents of America (IIAA) holds a get-together where agents from across the country can discuss all sorts of important matters. Three thousand agents attended this year's conference at that well-known insurance capital, Disney World.

Although meetings like these are generally considered junkets, meaningful things are sometimes accomplished. This year, for example, the National Board of State Directors passed the following resolution:

> IIAA should pursue an aggressive, targeted effort toward achieving industry consensus regarding the legal and economic framework and functions of national rating organizations, as well as other cooperative initiatives with companies that may serve well to diffuse continuing efforts to create unneeded burdens and unknowns for the insurance industry, which will ultimately penalize the consumer.

Emerson, Reid's Insurance Observer is offering a free one-year subscription to the first person who explains, in writing, what this means.

The Annals of Disability

SINCE 1988, Unum's claims for mental and nervous disorders are up 85%, carpal tunnel syndrome claims have increased 520%, and chronic fatigue syndrome claims have increased 800%.

The 5% Solution

THE PROGRESSIVE GROUP, which has achieved great success as a nonstandard auto insurance writer, expects to become an important player in the standard auto insurance market as well. The company's consumer research indicates that buyers want low prices, brand-name insurance companies, and customer service. "Progressive is going to be the lowest cost, highest quality auto insurer," declared CEO Peter Lewis to a group of securities analysts.

V.J. Dowling, of Hartford-based Paulsen, Dowling, reported that Lewis told the audience that "agents add very little value in personal auto" and must get used to operating on a 5% commission level. "If they can't do business for 5%, they don't belong in the system," he said.

Although agents and brokers bristle at the thought of any cuts in their commissions, before they try to hang Lewis from the nearest tree, they should remember one thing: he's right.

Sell Low, Buy High

IN MAY 1993, E. W. Blanch Holdings, a leading reinsurance intermediary, went public by issuing stock at a net price of $17.37 per share. In October 1994, Blanch announced that forty-four year old Michael Cashman, Sr., the company's president and CEO, had retired. In conjunction with this, Blanch bought 481,739 of Cashman's shares for $9.5 million ($19 7/8 per share) and agreed to buy another 481,739 shares in October 1995 and October 1996, at a price equal to 90% of the average price during the preceding month.

This transaction raises the obvious question: why issue stock, as Blanch did, and then buy it back at a higher price seventeen months later?

Jennifer Roy, the company's investor relations contact, tried to explain. "Michael Cashman, Sr., was our second largest shareholder. He didn't receive any severence package, and the sale of stock gave him financial flexibility." Ms. Roy also said Blanch had made considerable progress since its offering and that the stock buyback was "in the best interests of the shareholders" because Cashman's 10% stake could have been bought by someone who might try to take over the company.

Although Cashman is not obligated to sell his shares back to Blanch (he is restricted from selling to anyone else for two years), Blanch is obligated to buy his shares—no matter how high the stock price—if he chooses to sell.

Even if Blanch's stock doesn't go up, purchasing Cashman's shares could cost close to $30 million, which just happens to be the amount Blanch raised from its public offering.

Although Blanch is now a buyer of its shares, it may become a seller in the not-too-distant future. Says Roy, "It's likely that we'll need to raise capital sometime over the next two years."

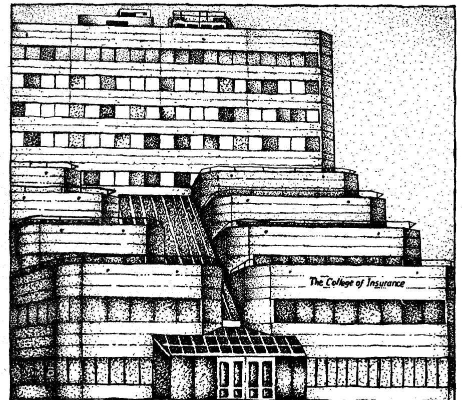
'A Host of Enemies'

SAUL STEINBERG, the rotund, youthful-looking 55-year-old chairman of Reliance Group Holdings, gave an impassioned speech before a crowd of five hundred at the annual conference of the Professional Liability Underwriting Society.

In a nasal, Brooklynese whine uncannily reminiscent of the comedian Gilbert Gottfried, Steinberg asserted that the insurance industry faces "enormous challenges from a host of enemies." His enemies list includes the "dysfunctional tort system," "the personal injury bar," regulators and politicians, and "the arrogant and complacent attitudes of many senior executives in our business," who, he said, seem to have forgotten their responsibility to their shareholders—namely, earning them a good return on their investment.

Although Reliance Group Holdings has not earned a good return on its equity, and shareholders have fared poorly for years, Steinberg takes home $6 million a year and his brother Robert, the company's president, gets about half that.

With friends like the Steinbergs, who needs enemies?



The College of Insurance, New York City.

Hank Greenberg, AIG's chairman, discovers that his company's plan to raise rates didn't go over well.

They all laughed when we said the property/casualty market would stay soft.

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- In January of 1990 we said First Executive looked like a goner. A little over a year later it was gone.
- In October 1994 we exposed A. M. Best's covert rating agenda and explained why its revised ratings definitions portended the downgrading of the weaker A– companies.

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