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SCHIFF'S INSURANCE OBSERVER

December 9, 2004
Volume 16 • Number 14

Forget it Jake, It's Chinatown

Regulation, Disclosure, AIG

Here comes the blind commissioner
They've got him in a trance
One hand is tied to the tight-rope walker
The other is in his pants

From *Desolation Row*, by Bob Dylan

New York Attorney General Eliot Spitzer makes insurance commissioners look bad. Even though he probably couldn't pass the final exam for Insurance 101, he has nonetheless uncovered big-time breaches of fiduciary duty, bid-rigging, price fixing, fraud, and conspiracies within the insurance industry. All of which raises several questions. Where were the insurance regulators when all of this was happening? Why is it that insurance commissioners seem to have so little interest in putting a stop to *obvious* frauds and scams? Is there a problem with the way insurance is regulated?

The problem, according to an October 21 *Wall Street Journal* editorial, is Mr. Spitzer himself, who has committed the sin of putting a "political spin" on the issues. In damning Spitzer, the *Journal* inadvertently depicts insurance commissioners as do-nothing buffoons: "Bid-rigging aside, Mr. Spitzer…is portraying as 'fraudulent' business practices that are long-standing and well known. *State insurance commissioners have known about them and declined to act for years*." [Emphasis added.]

On November 15, a *Journal* editorial blasted Spitzer again. "While society is served by holding individuals accountable for fraud, a bigger mystery is who gains from Mr. Spitzer's more sweeping assault on basic industry practices," it said. "So far as we can see, the answer is that these anti-corporate campaigns largely end up benefiting politicians and their allies in the trial bar." The *Journal* defends the insurance industry's bad behavior by saying that contingent commissions have "been around for decades" and that "state insurance regulators have never moved to bar them." Defending unsavory practices on the grounds that insurance regulators never got around to doing anything about them is not persuasive. Furthermore, the issue is not brokers' *receipt* of contingent commissions; it's brokers' *failure to disclose* the receipt to insureds.

The *Journal's* editorial asserts that there's a symbiotic relationship between Spitzer and plaintiff's lawyers. "Trial lawyers target an industry; politicians later get media kudos for pursuing said industry; lawyers, in turn, find their original cases bolstered in court."

What really bothers the *Journal*, however, is the fact that a brash outsider is shaking up a cozy system. "Legislators or appointed regulators…are made irrelevant by Mr. Spitzer's legal force majeure," it writes. "The companies involved pay a huge ransom to the trial bar, while shareholders watch the value of their holdings plummet, employees lose their jobs, or consumers pay more for goods and services once companies are forced to pay billions of dollars in settlements." The *Journal* has a solution that Hank Greenberg would like: tort reform.

Although insurance commissioners have never done much about the disclosure of brokers' and agents' compensation, that's changing rapidly. Log on to the website for The National Association of Insurance Commissioners (NAIC) and there—in big, bold letters—you'll see the following: "NAIC Drafts New Model Legislation Calling for Broker Disclosures." What follows is a November 16 press release that quotes the

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Every day the headlines bring new disclosures about shameful behavior by corporations, executives, financial institutions, and accounting firms. While cooking the books, insider trading, and various types of fraud may not be the norm, these practices aren't all that unusual. Despite our chronic skepticism, we're often shocked (but not really surprised) by the antisocial behavior of the business world.

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NAIC's president, Pennsylvania insurance commissioner Diane Koken. "One of the three components of our action plan is to achieve greater transparency through development of model legislation that will require brokers to disclose all compensation arrangements," she says.

From what we've observed, Koken hasn't been concerned about transparency or disclosure in the past. Large Pennsylvania insurers have been using lack of transparency and non-disclosure to bamboozle their policyholders for years—without intervention from the insurance department.

Provident Mutual, for example, (where Koken was general counsel, vice president, and secretary before becoming commissioner), concocted an abusive mutual-holding-company conversion that would have deprived its policyholders of $1.5 billion. Although Provident's conversion maneuver was deceptive and coercive, it was approved by Koken's insurance department after a farcical public hearing. (See *Schiff's*, May 1998, "Provident Breaks Covenant with Policyholders—Beware the Pennsylvania Insurance Department.") Policyholders represented by Kenneth A. Jacobsen sued to prevent the conversion, and Judge Stephen E. Levin of the Court of Common Pleas in Philadelphia County permanently enjoined Provident from effectuating the conversion after he concluded that Provident's officers had "breached their duty of disclosure" to policyholders.

Another example of Koken's laissez-faire attitude to policyholders being shafted by the non-disclosure of conflicts of interest can be found at the Harleysville Companies. NASDAQ-listed Harleysville Group is 56%-owned by Pennsylvania-domiciled Harleysville Mutual (which is owned by its policyholders). Over the last eighteen years, Harleysville Group—whose officers are also officers of Harleysville Mutual—has siphoned hundreds of millions of dollars out of the mutual through transactions that were not disclosed to, or approved by, the mutual's policyholders. These transactions include pooling changes that shifted seventy-two percent of premiums from Mutual to Group, reinsurance that transferred large catastrophe losses from Group to Mutual, fees that Mutual paid to Group, and $18.5 million that Group borrowed from Mutual at low interest rates.

There's a certain irony to the NAIC's call for greater disclosure from insurance brokers. Even though the NAIC is a *de facto* insurance regulatory organization, it is also a private, Delaware-chartered, 501(c)(3) tax-exempt corporation that's not subject to state or federal freedom of information laws. One of the NAIC's big businesses is the sale of data it receives from insurance companies. (State regulations require insurance companies to file their annual statutory statements with the NAIC.) These statements are the primary source of information and data about insurance companies. Despite the importance of these statements, they are not disclosed on any state insurance department's website. Nor have any insurance commissioners required insurance companies, in the interest of disclosure, to make the statements available for free on the Internet. The statements are not available on the NAIC's website, either. The NAIC does, however, sell them for $1.50 per page plus $10 for shipping and handling, which means that one statement can easily cost $500. (For more information on regulators' failure to make annual statements easily available, see *Schiff's*, July 16, 2003. For an excellent article on the NAIC's corporate status as both a private corporation and a governmental organization, see *The Insurance Forum*, October 2003, www.TheInsurance Forum.com.)

The Harleysville example of mutual-insurance-company chicanery mentioned above is not unique. The most egregious example is Allied Insurance Group, which siphoned more than $1 billion of value out of Allied Mutual. (For more on Allied, see every issue of *Schiff's* from October 1997 to August 1999.) Other companies that have employed variations on the technique include Kemper-Lumbermens, State Auto, and Alfa.

When mutuals convert to stock companies, they usually do so in a way that takes advantage of the owners of the mutual. Investment bankers won't admit this publicly, and most regulators don't care—or are ignorant. One money manger, however, admits that he loves to invest in mutual companies run sharpies who fleece their owners and breach their fiduciary duties. Granted, he didn't put it in those words. The October 4 issue of *Forbes* profiles John Keeley of Keeley Asset Management. He buys stocks that are out of favor or ignored by Wall Street. One category he's liked is mutual savings banks and insurance companies that convert to stock companies. Here's what *Forbes* wrote:

> Unlike other public offerings, Keeley explains, the point of mutual conversions isn't to raise equity capital but rather to prime the company for an acquisition. In the last fifteen years seventy percent of thrifts that have converted have been bought. Thus the incentive is to price the offering low, not high. "This is probably the cheapest entry point the stock will ever trade."

Keeley is correct. Mutuals' managements have an "incentive" to price their IPOs at a low price. If they were fair, how-

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Annual subscriptions are $189.
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ever, they wouldn't act on this incentive. And if insurance regulators cared about transparency and disclosure, they wouldn't allow a mutual to convert to a stock company without disclosing important facts about the value of the company to policyholders.

We live in a world of euphemisms. The Department of War, for example, became the Department of Defense in 1947. Afghan soldiers were "freedom fighters" when they were fighting the Soviet Union; now they're "enemy combatants." Government documents aren't secret; they're "classified." Undertakers are "morticians," garbage men are "sanitation workers." We use the "rest room" instead of the bathroom.

On November 9, when Marsh & McLennan released its third-quarter results, it began with a bullet point that stated, "Initiatives lead to annual cost savings of approximately $400 million." That sounds good, doesn't it? What were these profitable initiatives? "On a global basis we are reducing staff by five percent," Marsh said. Had Marsh been less euphemistic, it might have described the matter this way: "We're firing five percent of our employees and will incur $325 million of restructuring charges in the next six months."

The AIG division that played a key role in what the SEC called the "Brightpoint securities fraud" is not called the Earnings Management Unit or the Accounting Legerdemain Department. It is the Loss Mitigation Unit, and it seems to be in the business of helping companies smooth or manipulate their numbers so that they won't have to take large write-offs. As of last night, three examples of the Loss Mitigation Unit's services were described on AIG's website. (Go to http://www.aigcs.com/casestudy11.htm). Here's the first one:

Loss Mitigation Services

The following scenarios illustrate just some of the ways American International Companies' Loss Mitigation Unit can help companies overcome the obstacles posed by large-scale liabilities.

Easing Litigation's Negative Impact on Earnings

A company's CEO and officers are accused of insider trading, resulting in a stock drop. In the shareholder actions that ensued, a former D&O carrier sought an unfavorable allocation away from the directors and officers and towards the uninsured corporate entity. The LMU provided ongoing D&O coverage with a funding mechanism that covered the:

- Balance of the uninsured settlement
- Self-insured retention
- Defense costs
- Prior claims expenses.

As a result, the company's total "premium" was financed over a three year policy period, so the client avoided a one-time charge to earnings. In addition, the company's public disclosures of losses were able to assure constituents that "substantially all costs are covered by insurance."

AIG's website says that "The scenarios summarized above are fictitious and are offered only as examples. Coverage depends on the actual facts of each case and the terms, conditions and exclusions in each individual policy…"

So be it. But the example described above sounds strange, to say the least. Let's examine it. A company's CEO is accused of insider trading, its stock falls, and there's a problem with the D&O coverage. AIG's Loss Mitigation Unit comes to the rescue by providing a "funding mechanism" that covers an "uninsured settlement." The company's payment to AIG (which AIG refers to in quotes as a *premium*), is "financed" over three years so that the company won't have to report a one-time charge.

Because AIG put the word *premium* in quotes, one must presume that what is being paid is not really a premium, just something that *appears* to be a premium. If the premium is not really a premium, then one must also presume that the company isn't buying insurance. But, if the company is just "funding" an uninsured settlement over three years, how can it avoid taking a one-time charge for an expense it has already incurred? Finally, if the company is using a "funding mechanism" to "finance" over three years a loss that has already occurred, isn't it fraudulent for it to "assure" its shareholders that "substantially all costs are covered by insurance"?

Perhaps these questions are moot because, as AIG's website notes, this scenario is "fictitious." The funny thing about it though, is that it sounds remarkably like AIG's transactions with Brightpoint, in which the SEC found that AIG's Loss Mitigation Unit issued a sham insurance policy so that Brightpoint could avoid a one-time charge through some phony accounting. The SEC called the transaction a "round-trip of cash" in which Brightpoint paid AIG a fee, and then paid monthly "premiums" which it received back in the form of "insurance claim payments."

In 2003, AIG paid a $10 million penalty to settle the SEC's charges of fraud in the Brightpoint transaction. AIG neither admitted nor denied that it did anything wrong, but it agreed to cease and desist from committing or causing securities violations.

On November 30, AIG announced that it had "reached a final settlement with the Securities and Exchange Commission (SEC), the Fraud Section of the United States Department of Justice (DOJ), and the United States Attorney for the Southern District of Indiana with respect to issues arising from certain structured transactions with Brightpoint, Inc., The PNC Financial Services Group, Inc. (PNC) and related matters." The settlement included paying $126 million in penalties and having an independent consultant review various AIG transactions that took place between 2000 and 2004. AIG also agreed that it won't make or permit to be made any public statement denying the SEC's factual allegations of AIG's corrupt behavior.

AIG's announcement quoted chairman Hank Greenberg. "In anticipation of this settlement, AIG has been forming a Complex Structured Finance Transaction Committee comprised of senior executives from the business and from the finance, legal and claims functions," he said. "This committee will help assure that no product we market in any part of our organization is sold to assist a counterparty or an insured to misrepresent either its income statement or balance sheet."

We suggest that the committee start by taking a look at the Loss Mitigation Unit's website, particularly the scenario about "funding mechanisms" that are "financed" over three years to allow companies to avoid one-time charges to earnings. ■

THE ANNUAL
SCHIFF'S
INSURANCE CONFERENCE
Tuesday, April 12, 2005
in New York City