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Property-Casualty Rates To Rise

A Warning From Sean Mooney

As is the case of most insurance musings, *CRISIS and RECOVERY: A Review of Business Liability Insurance in the 1980s*, by Sean F. Mooney, is not great literature—far from it. Nonetheless, it's provocative. Mooney, the senior vice president and economist at the Insurance Information Institute, sheds light on what were the golden days of insurance (for brokers, anyway)—the hard market of the mid-1980s—when the price of liability insurance doubled or tripled, if insurance was available at all.

Although Mooney falls far short of saying that the cause of the crisis was the stupidity of the folks running insurance companies—that wouldn't be an easy thing for him to say since the Insurance Information Institute is supported by the insurance industry—he demonstrates that part of the industry's problem stems from denial. Although general liability premiums actually declined slightly between 1980 and 1983, incurred claims were

increasing rapidly. (See charts on page 2.) The consequence was inevitable: premiums had to be raised sharply.

Why didn't the market turn before 1985? "Most analysts point to the fact that the capital of the industry declined in 1984," writes Mooney. "It had increased in every other year since 1973—and this led to a change in market psychology, triggering the turn."

The crisis subsided just a few years after it began, and since 1988 paid claims (a lagging indicator) have stabilized. Mooney attributes this, indirectly, to statutory tort reform. He writes: "Following the liability crisis of 1985-1986, statutory tort reforms were passed in over forty states. By the end of 1991, thirty-three states had modified or abolished the joint and several liability rule, twenty states had modified the collateral source rule, eight states had placed caps on non-economic damages, and punitive damages were either capped or limited in twenty-seven states."

Although a study by Insurance Services Office, Inc. (ISO) reported that less than 15% of claims would be affected by enacted tort reforms, Mooney believes that "judges should and do take account of prevailing public attitudes in making changes in common law." Therefore, "statutory tort reform, even when weak, plays a key role in influencing judicial thinking. . . . The liability crisis dramatically showed judges that their individual decisions were leading to a general collapse of the entire liability system."

Although Mooney's study has a

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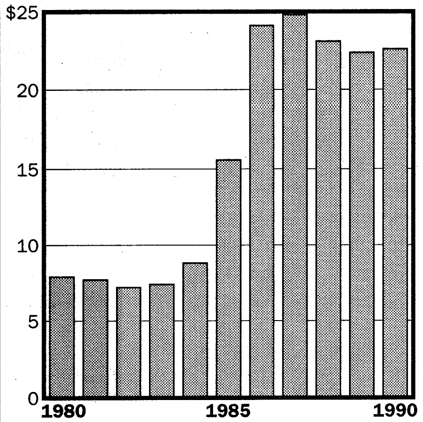
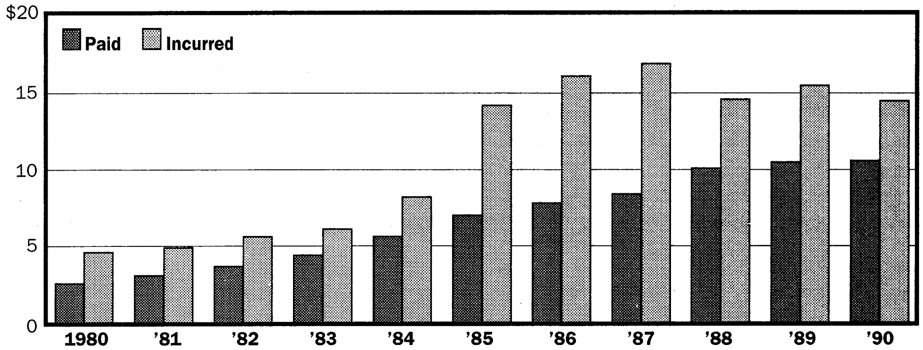
General Liability Premiums
(billions)



Source: A.M. Best, Insurance Services Office.

General Liability: Explosion In Incurred Claims
Paid Claims and Incurred Claims (billions)

The large increase in incurred claims for 1984 and 1985 is the result of substantial additions to reserves, not increases in paid claims—evidence that insurers had been significantly underreserving in prior years.



Source: A.M. Best, Insurance Services Office.

happy ending—the liability crisis was ultimately contained—he concludes with a warning: "Unless there is continuing pressure for reform, probabilities favor another major liability crisis occurring during this decade."

Intrigued, we headed to 110 William Street, home of the Insurance Information Institute, in search of the author.

Sean Mooney, an engaging fellow from Ireland, got his degree from UCLA and then worked for W.R. Grace as an international economist. His next stint was at Pan Am, but the dismal economics of the airline business soon became clear to him so he looked around for another industry—one in the process of change—that might need the services of an economist/strategic planner. He joined the Insurance Information Institute in 1982.

Mooney sees similarities between the airline and insurance industries. Both sell commodity products, and competition is based on price, and, to a lesser degree, service. "It's hard to see the insurance industry achieving above average rates of return," says Mooney. There's just too much competition, which is typical of commodity-type industries. Other than financial strength, there is little brand differentiation in commercial lines.

The personal lines business isn't quite as bad. "There are some very valuable franchises," Mooney says. "State Farm, USAA, and 20th Century" were a few that came to mind.

So what lies ahead for the casualty market? Mooney sees some tightening, but nothing too extreme. "It doesn't look like companies won't be able to get insurance," he says. "Maybe prices will be up 15%. But I don't see a repeat of 1984 and 1985."

Mooney thinks there's a greater chance of a crisis in property insurance. "This year there's been $3.8 billion in catastrophe losses. [Before Hurricane Andrew.] That's higher than all of last year." The most likely cause of a crisis is still a huge earthquake. In his 1989 report, *Insurer Insolvency and Earthquake Insurance*, Robert Litan explained the devastating effect of a "big one." An earthquake causing $50 billion of damage could wipe out one-third of the industry's surplus.

Although the insurance industry has been contemplating this issue—there are various position papers, and legislative proposals—nothing of substance has been done yet.

What could cause another liability crisis? Mooney thinks he knows the answer. "Lawyers. Look at the numbers of them coming out of law schools," he says in amazement. "They have to do something."

EMERSON, REID'S
INSURANCE OBSERVER

David Schiff, Editor and Writer

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Hard Market Might Not Be Good News

Would-be borrowers all over America have a familiar complaint: although interest rates are low, banks aren't lending. To some extent that's true. Banks are eager to make loans to big, solvent companies. These companies, however, don't have much demand for credit, especially not the bank kind, which carries a 6% interest rate at a time when ninety-day commercial paper is yielding 3.27%.

So, for now, anyway, money-center banks believe that lending isn't the easiest way to make money. Lending, as they see it, involves risk but not much reward. So banks are playing the yield curve—taking in short-term deposits and buying longer-term treasuries—and engaging in exotic-sounding transactions such as swaps, hedges, and currency trading. The current situation is the reverse of the 1980s, when it seemed that banks turned away no one seeking a loan—with disastrous results.

The economics of the insurance industry are similar to banking's. Like lending, property-casualty underwriting is a game with slim margins, at best. Underwriters and insurance company executives profess knowledge of this, but have nonetheless let themselves get sucked into the price-cutting vortex on the theory that when the market turns they'll have the market share to ensure fat profits.

Although the cost of insurance for most commercial buyers has been declining for about five years, it is foolish for buyers to presume that rates will remain permanently low, or that insurance will always be available. It is equally foolish for insurance brokers and underwriters to believe that the market will never harden. The insurance market—like all markets—works in unpredictable ways, and the twists and turns often work out unpleasantly. Although a July 23 *Wall Street Journal* headline proclaimed "One Expensive Disaster Could Reverse Trend, Boosting Fees and Profits," we doubt it's that simple. Although many insurance people are secretly praying for some sort of natural disaster to force reason and discipline onto the market, we recall the aphorism that "more tears are shed over answered prayers than unanswered ones."

The last hard market drove many big insurance buyers to self-insurance, and they haven't returned yet. (An analogy to banking: banks' best customers—Fortune 500 businesses—became competitors when they entered the commercial paper market.) Insurance companies won't always be there to write bad business at a low price, anymore than banks are still there to make bad loans. One day the well runs dry. And, as they say on Wall Street, they don't ring a bell to tell you when it's going to happen.

It is always possible that the insurance marketplace will somehow accommodate the brokers and underwriters praying for a hard market. Perhaps rates will rise gradually, say ten or fifteen percent a year for the next five years, and combined loss ratios will trend downward to the hundred percent level. We'd bet against that scenario, but it is possible.

We think that the likely cause for a turn in the market will be financial pain. How it is caused is irrelevant. It could be the result of massive underreserving (as was the case in the early 1980s); it could be the result of disastrous investments (much less likely in the property-casualty companies than in the life companies); or it could be a catastrophe. If it's a catastrophe of severe proportions, we doubt the industry will be rejoicing when rates start rising. The scenario might look like this: Several large carriers report terrible losses. There are rumors of bankruptcies. Buyers refuse to use lower-rated carriers. Capacity drys up. Several reinsurers go bankrupt. Umbrella layers can't be completed. Premiums soar, but insurance isn't widely available.

Is this scenario likely? Perhaps not. Is it possible? Definitely. ■

Equitable Life: Out of the Frying Pan?

In mid-July, The Equitable Companies, Inc. sold $450 million of common stock in a public offering. This was less than half what the company had originally planned to raise, and the price of the stock—$9 per share—was more than a third lower than hoped for. Still, the money was gladly accepted. This was a do-or-die deal for Equitable, and had the deal not been completed, the ramifications could have been frightening: rating agencies might have lowered their ratings, insurance buyers might have shied away from the already lower-rated Equitable, or policyholders and annuitants might have staged a run.

Delinquent Mortgages

Although Ross Perot (remember him?) never pronounced Equitable insolvent (as he did the nation's largest bank), a perusal of its prospectus is not reassuring, unless you're short the stock. For example, 63% of the company's $1.3 billion in surplus is the result of surplus-relief insurance. But the most serious ongoing problems are the $7.988 billion mortgage and $4.354 billion equity real-estate portfolios, which together comprise a whopping 38% of General Account assets.

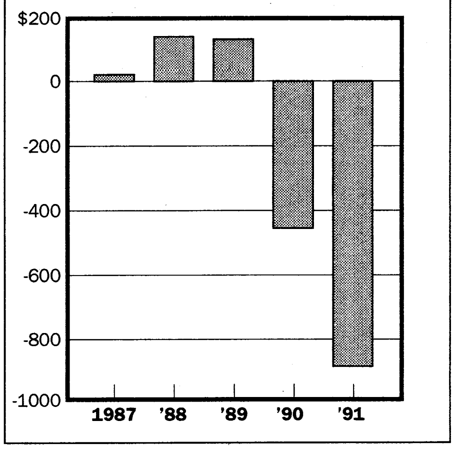
Equitable's real estate experience has been dismal—a result of its overly aggressive posture in the 1980s—and there's no turnaround in sight. Although Equitable's current loan-to-value guideline for new mortgages is 75% (it isn't making many new mortgages), it made a significant amount of mortgage loans at higher loan-to-value ratios during the 1980s. Compounding this mistake, a majority of those loans were balloon mortgages—that is, principal was not paid down during the term of the loan. During the next five years, $3.4 billion of these lead balloons are scheduled to mature. If the recent past is any indicator, there is little chance that these mortgages will be repaid on time. In 1991, only 33% of the $422 million of mortgage maturities owed to Equitable were paid as due, and during the first quarter of 1992 just 7.2% of scheduled mortgage maturities were paid as due. This non-payment poses a potential liquidity problem for Equitable because, by the end of 1995, it must redeem $5.8 billion of the GICs it issued.

The gravity of Equitable's real-estate problem can be summed up by the net yield on its mortgage portfolio—just 6.53% in 1991. That looks positively wonderful, however, when compared to the *minus* 3.21% net yield on its equity real estate. These poor results aren't surprising considering that 41.8% of Equitable's commercial mortgages and 70.3% of its equity real estate is invested in office buildings—the worst sector of the real estate market.

Given the risky loans made, the repayment problems, and the depressed office market, an investor in Equitable might want to consider whether the valuation reserves the company has on its various real estate investments are adequate, and how those reserves compare to those of other real estate investors.

The Equitable Life Assurance Company: Real estate deflation takes its toll.

Money Loser
The Equitable Companies, Inc.
Net Income (millions)



As of March 31, 1992, Equitable's valuation reserve was 2.5% on its commercial mortgages and 4.5% on its equity real estate. By way of comparison, Travelers has taken a 5.36% valuation reserve on its mortgage loans and real estate.

A skeptic might wonder whether Travelers and Equitable have kept their reserves low (more optimistic) in order to make their financials appear better to Wall Street. So far this year Travelers has tapped the fixed-income markets to the tune of $675 million, and Equitable got $450 million of equity.

One company that isn't looking for money, and has no reason to put its best foot forward, is Mutual Benefit Overseas, Inc. This Mutual Benefit Life subsidiary, which is currently in default on its $400 million of debt (we have recently purchased some of these Eurobonds), owns a seasoned, diversified pool of commercial mortgages: apartment and retail properties each represent 26% of the portfolio; office buildings represent just 21.8%. Although the mortgages weren't balloons written at high loan-to-value ratios during the real estate bull market, the results have been bad anyway: 15.9% of the mortgages are thirty or more days delinquent. At year end 1991, Mutual Benefit Overseas' valuation reserve on its mortgage portfolio was 8.06%. This reserve, as a percentage, is three times greater than the reserve Equitable has taken on its mortgage portfolio.

Why is it that the seemingly more conservative mortgage portfolio—that of Mutual Benefit—is also the one that has the largest reserve? It's possible, of course, that Mutual Benefit's mortgage portfolio, though seasoned, amortizing, and written at lower loan-to-value ratios, contained a higher proportion of duds, or was distorted by a few extremely bad mortgages. On the other hand, Equitable's experience may well turn out to be much worse than its 2.5% reserve leads one to expect. Equitable admits as much: "No assurance can be given that such allowances will in fact be adequate to cover all future losses." Equitable also admits (as do Travelers and Mutual Benefit Overseas) that if it tried to bail out now, under "current depressed market conditions," it would recover "substantially less than the related carrying values" for a significant portion of its portfolio.

The Equitable
Investment Results by Category

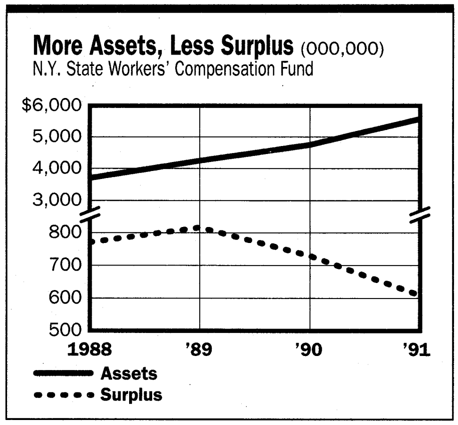
	1989	1990	1991
Fixed Maturities	10.49%	9.47%	8.21%
Mortgages	9.27%	8.62%	6.53%
Equity Real Estate	13.47%	(0.03%)	(3.21%)
Equity Interests	(1.65%)	(0.70%)	5.57%

Given Equitable's real-estate investment problems, its disastrous foray into GICs and concomitant move into junk bonds and junk real estate, it is ironic that its prospectus lists "investment expertise across a broad array of asset classes" as one of Equitable's "two core strengths."

One can only surmise what Equitable's balance sheet would have looked like if "investment expertise" *hadn't* been a "core strength." ■

Brother, Can You Spare a Billion?

Can The State Fund Go Bust?



In 1920, Charles Ponzi hit upon a get-rich-quick scheme of remarkable simplicity: he'd offer folks a 50% return on their money every ninety days. The concept clicked. Credulous investors chose not to ask how such a return was possible—at those rates a $1,000 "investment" would have grown to $1 million in a little over four years—and Ponzi took in $15 million before his fraudulent pyramid collapsed. Today, Ponzi's name is invariably linked with the word *scheme*, and *Ponzi scheme* has entered the lexicon as an investment swindle in which early investors are paid off with money put up by later investors.

Although not a Ponzi scheme, The New York State Workers' Compensation Fund bears striking similarity to Ponzi's handiwork in three ways: it takes in money in return for a promise to make a payment in the future; its promoter, New York State, has withdrawn almost $1.3 billion from The Fund, a figure more than double The Fund's total surplus; it appears that there is not enough money in The Fund to pay off claims.

How The Fund's finances got to this sorry state is not a surprising story. The Fund is a victim of the process known as government, and over the past decade it has become a political piñata: it has been knocked about and skewered and its assets have been grabbed. Since 1982, the New York State legislature has passed a series of laws requiring that $1.295 billion be transferred from The Workers' Compensation Fund to the state. This fiscal legerdemain had the effect of reducing New York State's deficit by a like amount. (Why the shuffling of assets and liabilities between the state and its agencies should have any effect on the budget is another matter altogether.) In any event, that $1.295 billion is now carried on The State Fund's balance sheet as a non-interest bearing "contingent receivable."

The state probably wouldn't have had the gall to siphon so much money from The Fund unless The Fund looked flush. Unfortunately, The Fund was in the poorhouse—at least according to the accounting principles then in use. This was remedied with a stroke of the pen, however. In 1986, The Fund began discounting its Losses and Loss Adjustment Expenses to its present value using a 3½% interest rate. In 1989, it switched to a 5% discount rate. This balance-sheet jiggering has created $1.529 billion of additional surplus as of year-end 1991. (Without this accounting magic The Fund would have shown a *deficit* of $924 million in 1991 instead of surplus of $606 million.)

Were The State Fund an immensely profitable organization it could, perhaps, withstand a raid on its assets. However, The Fund is not profitable. Its results from operations, before accounting changes and investment gains or losses, have been dismal. In 1989, 1990, and 1991 it lost $146 million, $39 million, and $95 million, respectively, on combined loss ratios of 147%, 128%, and 133%. Total surplus has declined from $829 million to $605 million over the last three years.

The Price of Politics: N.Y. State Workers' Compensation Fund (000 omitted)

Assets		Liabilities	
Total Investments	$3,803,270	Losses and loss adjustment expenses	$4,017,464
Contingent Receivable from New York State	1,295,000	Other	840,819
Due from New York State and Urban Development Corp.	181,966	TOTAL	$4,858,283
Other assets	183,963	TOTAL SURPLUS	$605,916
TOTAL	$5,464,199		

12/31/91

If the folks in charge of The State Fund are concerned about this grim trend, they gave no indication of it in The Fund's 1991 annual report. Governor Mario Cuomo commended The Fund's honchos for their "commitment and dedication." Chairman Martin A. Fischer's cryptic words avoided the issue: "The goals we set for 1991 exceeded our expectations." (What does that mean? Goals are similar to expectations, aren't they?) Executive Director Cecilia Norat was upbeat, writing, "I am pleased to report the financial results of 1991." She didn't explain why reporting three years of losses was pleasing.

If The State Fund were a private insurance company one would, undoubtedly, cast a skeptical eye towards it finances. One could not ignore The Fund's losses, its use of less conservative accounting methods, and the "hole" in its balance sheet—the $1.295 billion contingent receivable. However, The Fund is not a private company; it is a nonprofit agency of the State of New York. As such, does it matter what sort of financial condition it's in?

Yes. To whom? To New York citizens, for starters. At some point The Fund's huge deficit must be made up. This can be accomplished by earnings—which in the past have been elusive—or by an infusion of cash from the state. Since the workers' compensation market is intensely competitive, and since The Fund gets its business by offering low rates, earnings aren't easy to come by. On the other hand, given New York State's difficult financial situation, repaying the contingent receivable would be an unpopular political move.

Policyholders too, could have reason to be concerned. There can be no assurance that the state can make good on its obligations, although, granted, such a turn of events sounds farfetched. But states and municipalities have defaulted on their obligations in the past and may do so again in the future. Unlike the federal government, which can make up its deficit simply by printing more money, the state has no printing press. It can issue bonds, but those must eventually be repaid or refinanced.

So, can The State Fund go belly up? That question was posed to Cynthia Monk of the State Comptroller's office. (The Comptroller has long been critical of The Fund's accounting shenanigans.) Ms. Monk, a diplomatic woman, skirted the issue. "One would assume that before it got to that situation something would be done. Perhaps premiums would be raised."

Raising premiums might backfire, however. The State Fund attracts business because its rates are low. Higher rates might cause policyholders to stay away in droves.

Ms. Monk then offered that the state could arrange journal transfers to make up the shortfall.

And where would the money for the transfers come from?

"That question is best posed to the legislature or the governor," Ms. Monk said with a touch of exasperation. After all, the Comptroller doesn't decide how the money gets spent—he just keeps track of things. And therein lies the problem. Undoubtedly, the legislature and the governor will respond that everything is just fine and that if money were ever needed to make up any shortfall it would be no problem.

But, if there's one lesson we've learned from the banking disasters, the savings & loan mess, and Mutual Benefit, it is this: saying things are all right doesn't make them so. ■

Déjà Vu All Over Again

The country is locked in a recession so severe that even the largest life insurance companies are experiencing great difficulties. The president of the United States, an ineffectual man surrounded by his advisors—mostly members of the eastern establishment —is hopelessly out of touch and his popularity ratings are near their all-time low.

George Bush in 1992, right? No, Herbert Hoover in 1932.

That was the year the Republican platform defended a terrible piece of legislation, The Smoot-Hawley Tariff, and pledged the continuance of the gold standard. The Democrats also favored a sound currency, a balanced budget, and the gold standard (as well as repeal of the 18th amendment.)

Treasury Secretary Andrew Mellon advised Herbert Hoover to "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate."

Roosevelt, who was no radical, advocated reducing government expenditures by cutting waste.

Hoover's presidency, clearly, was a failure. Whether or not Richard Nixon's observation is correct—that Hoover "had the misfortune to hold office at the wrong time."—the Depression happened on his watch.

In *Money of The Mind* (A must read. Farrar Straus Giroux; $25) James Grant explains that Hoover (and not FDR) was the "principal architect" of the 20th century movement towards the socialization of credit (credit meaning lending and borrowing), noting that the Great Depression "was the first in American history to be met by active federal government intervention. Under Hoover, the National Credit Corp. and the Reconstruction Finance Corp. were formed, and the Glass-Steagall Act of 1932 and the Emergency Relief and Construction Act became law. In one way or another these programs extended government credit to the private sector. Unfortunately, "The Hoover program yielded few tangible results in the Depression," Grant writes, "but contributed mightily to the expansion of credit in subsequent generations."

Hoover cut taxes in 1930 and 1931,

(continued on page 8)

and, even though he firmly believed in a balanced budget, ran a huge peacetime deficit.

Although the ravages of the Depression were evident to the common man, they were less clear to business leaders, who believed that the Depression would eventually run out of steam once the excesses had been wrung out. (OLD JOKE: What's the difference between a recession and a depression? Answer: In a recession your neighbor is out of work. In a depression *you're* out of work.) Treasury Secretary Andrew Mellon offered Hoover this harsh advice: "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate" and so "purge the rottenness from the economy." Historian Paul Johnson called this "the only sound advice Hoover received." Had Mellon's advice come several years earlier, before the excesses got out of hand, it might well have been sound. But coming as it did during a time when a quarter of the population was out of work, it was, in William Manchester's opinion, "social Darwinism."

Hoover, who was known to dine in luxury each night, was quoted saying "Nobody is actually starving. The hoboes, for example, are better fed than they have ever been. One hobo in New York got ten meals a day." (Two generations later, Ronald Reagan—who was equally oblivious to suffering—would tell stories of welfare queens dining on steak and champagne.) In 1932, Hoover vetoed a $2 billion relief bill, declaring "Our nation was not founded on the pork barrel."

By the time FDR took office, the country was paralyzed by fear, and bold, radical measures were necessary. "Above all, try something," said Roosevelt.

He did.

Ironically, there was a candidate in the 1932 election who advocated bold, progressive measures. His name was Norman Thomas and he was a Socialist. His party's platform was considered radical, even though its ideas—many of which have come to pass—don't sound very radical today. Thomas advocated public works, unemployment insurance, old-age pensions, health insurance, minimum wage laws, low-cost housing, a five day work week, and civil rights. "Vote your hopes and not your fears," he said. "Don't vote for what you won't want and get it."

He received 884,781 votes, about 2.2% of the popular vote. ■

New Jersey TDB

Unlike New York, where most of the DBL is written with private carriers, in New Jersey, most of the TDB (Temporary Disability Benefits law) is written through the State Fund, which (obviously) doesn't pay any commissions. That's crazy! Emerson, Reid has a number of very competitive markets that are actively seeking TDB.

Here's a refresher in TDB: The law requires employers in New Jersey to provide short-term disability benefits to their eligible employees who are unable to work because of an off-the-job injury or sickness.

The benefit as of January 1, 1993 will be $66\frac{2}{3}$% of the average weekly wage to a maximum of $304 per week. Rates are a percentage of the first $16,100 of annual wages per person.

Benefits begin on the eighth day of disability. There is a twenty-six week duration. If an employee is disabled for three consecutive weeks following the waiting period, benefits are retroactive to the first day of disability.

There's a decent amount of paperwork involved in writing TDB, and, since most policies have to be effective January 1, it's important to get started as soon as possible.

Product For The '90s: Long Term Disability

Even though demand for Long Term Disability has been growing rapidly, only 27% of American income earners have any form of disability coverage, while 85% have some form of health insurance. And, even though most working people have a much greater chance of becoming disabled than dying (a thirty-two year old is $6\frac{1}{2}$ times more likely to be disabled for ninety days than to die) life insurance is much more prevalent.

Ultimately, Long Term Disability will be as common as health insurance is now, but it will take a while. In the meantime, the situation provides brokers with an opportunity that's quite rare in the insurance business—a major risk that is mostly uninsured.

Emerson, Reid has long been recognized as the leading general agent and specialist in the statutory and short-term disability market, and we've carved out a niche for ourselves in the Long Term Disability market as well.

So give us a call.

New York DBL: Steady Growth

Primarily because of inflation, the average weekly benefit rate, indemnity payment per employee, and payment per claim, have risen steadily over the past two decades. The average duration of benefits (which isn't affected by inflation) has also trended up over time, rising from 7.7 weeks in 1970 to 8.7 weeks in 1982, before declining slightly to 8.4 weeks in 1989.

LETTERS TO THE EDITOR

One of the agents we share in common was kind enough to send me a copy of your June 1992 Insurance Observer. I very much enjoyed your insightful analysis of the current insurance scene and particularly your annual report comments.

Keep up the good work!

Walter A. Rhulen, CPCU
President
Frontier Insurance Company

Thank you for your Insurance Observer of June 1992. I found it very interesting, easy to read, and true to life.

Thomas B. Rice
New York, N.Y.

We enjoy receiving comments from our readers, so please write. Letters should be addressed to David Schiff, Emerson, Reid & Company, Inc., 10 Columbus Circle, New York, N.Y. 10019.

We are also interested in publishing articles by our readers, so call if you've got a good idea.