EMERSON, REID'S

Vol. 4 • No. 4 INSURANCE OBSERVER December 1992

Round Up The Usual Suspects

AIG's Modest Proposal

In the wake of Hurricane Andrew, AIG's Jeffrey Greenberg wrote an internal memo telling his company's field force that this was their chance to "get price increases now." When the memo found its way to the press, the reaction was predictable: Outrage! Politicians, insurance regulators, consumer advocates and others saw this as proof of a conspiracy and called for an investigation. Apparently they were shocked, shocked to discover that insurance companies were in business to make money.

We too were shocked—that anyone was surprised by Greenberg's memo. After all, his father, AIG's chairman Hank Greenberg, has been saying the same thing for a couple of years now and nobody's paid any attention, much less called for an investigation. As Greenberg knows, rates won't go up because he wants them to; they will go up when insurance companies throw in the towel and say they're too scared to write insurance, even at higher prices. Precisely when this will happen is anybody's guess, but it will happen.

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

In the headline of our September issue we announced: "Property-Casualty Rates To Rise." Our conviction had to do with the length of this downcycle, a sense that insurance companies are underreserved, and the fact that you can't legislate away catastrophe.

Risk is the uncertainty of loss. By definition, insurance companies are in the business of facilitating the transfer of risk, for a fee. Uncertainty—the odds of a loss occurring—is the key variable in the pricing of risk. Although the odds are reasonably well known, from time to time the insurance industry ignores them and engages in brutal price competition. Now is one of those times when it's cheaper to transfer risk than retain it, which shouldn't be the case. Rather than acting like a casino, the insurance industry is acting like a high roller.

American Reliance Insurance Group is one company that gambled and lost. It was rated A+ prior to Hurricane Andrew, A– shortly after, and NA-11 (Rating Suspended) now. Its stock has fallen from $25½ to around $7, and its surplus will be sliced in half—or perhaps worse—as a result of the hurricane. While this is meaningless in the big scheme of things, it's always a bit startling to be reminded of the fragility of insurance companies. If the status of an A+

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company can change that rapidly, what can happen to lesser-rated companies?

Regulators are in no better shape than the insurers. Not only are they understaffed, they are also underfunded. According to *Business Insurance*, the Florida Insurance Guaranty Association is now "scrounging for funds" to pay as much as $280 million of claims filed by policyholders of failed insurance companies. The Guaranty Association, however, only has $30 million. To be sure, it will get its hands on more money—somehow. It has already assessed insurers 2% of their annual premium volume—the maximum allowed by law—but this will raise just $65 million. "It is a serious situation," said Jerry Service, the manager of the fund.

If the insurance cycle has bottomed out and rates are indeed going to rise, there has to be a reason for it, and it should be better than "it's just that time." The insurance cycle has always been rooted in economic reality. Profitable underwriting encourages others to enter the business, which causes price competition, which causes profits to shrink and then disappear. Eventually losses develop, forcing the marginal players out of the game, allowing prices to rise once again. Historically, this cycle followed a wave pattern, probably because losses were easy to recognize. But these days losses aren't so easy to detect. For example, how large are the pollution and hazardous waste liabilities that the insurance industry will ultimately pay? The Savings & Loan mess is another example of catastrophe coming out of nowhere. Someone in the know recently told us that one of the giant specialty risk underwriters is taking triple $10 million hits with almost every S&L failure: on the lawyers' E&O, on the accountants' E&O, and on the D&O.

The insurance industry has approximately $160 billion of reported capital. (That's about half the nation's annual budget deficit.) If that figure is correct, the industry is overcapitalized and rates probably won't go up. After all, why would profits rise in an industry awash in capital?

But what if a good part of that $160 billion—say $75 billion—is illusory? That happens to be the view of David Seifer, an analyst at Donaldson, Lufkin & Jenrette. He believes the industry is seriously underreserved. If he's right, it's in terrible shape. There is a silver lining to this: rates would have to rise sharply and the strong companies should clean up. (Already, the first signs of tightening may be appearing in the high limit layers of the umbrella market.)

Even if the industry is massively underreserved, until insurance companies *realize* this the market won't turn. Insurance companies are like the cartoon characters who run off a cliff and keep running on air—until they look down.

Someday, perhaps soon, insurance companies will look down. ■

Playing With Fire

The Early Days of American Insurance

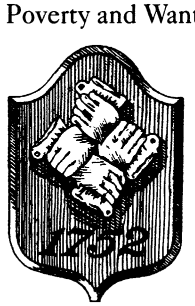
America's first recorded fire—and its first recorded uninsured fire—happened in Jamestown, Virginia in 1608. "Most of our apparel, lodging, and private provision were destroyed," wrote Captain John Smith in his journal.

"Noe man shall build his chimney with wood, nor cover his house with thatch," read the country's first fire prevention regulations, enacted twenty-two years later, in Boston.

Although the American fire insurance industry has a colorful history, little has been written on its early days, and there seems to be no definitive book on the subject. That hasn't stopped us from piecing together what turns out to be a charming historical overview, beginning with the dawn of fire prevention, and taking us up to the end of the nineteenth century.

The first organized fire fighting began in 1648, during Peter Stuyvesant's administration as governor of New Amsterdam, and it was another century before the Union Fire Company—the first volunteer fire company—was organized in 1736 by Philadelphia's Benjamin Franklin. ("Never leave till to-morrow which you can do today.") Fire prevention was of great concern to Franklin. In fact, his oft-repeated maxim, "An ounce of prevention is worth a pound of cure," comes from his newspaper editorial, "On the Protection of Towns from Fire."

The first American fire insurance company—the Friendly Society for the Mutual Insuring of Houses Against Fire—was formed in Charleston, South Carolina on January 3, 1736. The company's articles of agreement stated that "the Insurance of Houses against Fire hath by experience been found to be of very great service to many Persons who would otherwise have been reduced to Poverty and Want."



Premiums, which were 1% of insured value, were paid into an investment fund. If the fund proved insufficient, each policyholder could be assessed his proportionate share of the losses. The Friendly Society operated successfully until November 18, 1740, when a fire destroyed more than three hundred houses in Charleston and bankrupted the fledgling insurer. As Donald Armstrong observed in his 1971 doctoral thesis, *A History Of The Property Insurance Business In The United States Prior To 1890*, this disaster highlighted two mistakes that would be made time and time again, especially by mutual companies: "inadequate financial resources and the danger of concentrating risks in a single area."

EMERSON, REID'S
INSURANCE OBSERVER

David Schiff, Editor and Writer

EMERSON REID'S INSURANCE OBSERVER is published by Emerson, Reid & Company, Inc., the leading General Agent, Intermediary and Specialist in New York DBL, 10 Columbus Circle, New York, NY, 10019. Telephone: (212) 765-2103. Subscriptions are free to insurance brokers and agents, and $30 for others.

In 1752, Benjamin Franklin founded the Philadelphia Contributionship for the Insurance of Houses for Loss by Fire, also known as the "Hand in Hand" because of its now famous firemark of four interlocked hands. Policies were written for a seven year term, and only on properties located within ten miles of Philadelphia. The maximum policy limit was £500, and every building was inspected before a policy was issued.

In the company's first year of operation, 147 policies were written. There were no fires. For the next thirty-two years the Philadelphia Contributionship was the only fire insurance company in America. Underwriting standards were rigorous. According to *Insurance Perspectives*, the company wouldn't insure sugar houses, brew houses, bake shops, coopers shops, apothecaries, chemists, ship-candlers, tallow chandlers, stable keepers or buildings that stored hemp, flax, tallow, pitch, tar, turpentine, hay, straw, and fodder. In 1769, the Contributionship stopped writing insurance on wooden buildings. In the 1770s, it stopped insuring houses with trees in front of them, as these interfered with fire fighting. In 1784, a number of policyholders who valued their shade trees defected and formed another company, the Mutual Assurance Company, better known as the Green Tree Mutual. That company prospered too, and by 1800 had a surplus of $25,400. The Green Tree began issuing perpetual policies in 1801, and the Philadelphia Contributionship followed suit nine years later. Both companies are still in existence today, and are located a block apart from each other. (Profiles of these companies will appear in our next issue.)

Some other early insurers include the Mutual Assurance Company of the City of New York, founded by Alexander Hamilton in 1787, and the Mutual Assurance Society Against Fire on Buildings in Virginia, founded in 1794 by Chief Justice John Marshall.

Although mutual companies were to constitute a significant percentage of the insurance companies during the nineteenth century, they would make up only a small percent of the industry's assets. Still, they were an important source of insurance, especially in small towns where they were often the only source. "As long as they remained in rural areas among scattered risks, mutuals were able to avoid large losses which would have destroyed them because of the inability to raise capital quickly," writes Armstrong. Many of the mutuals operated on credit—the insureds promised to pay each others claims—or were capitalized by notes from their insureds. Not surprisingly, when these notes were called—usually after a disaster—the insureds often resisted paying. This was especially troublesome since the mutuals tended to pay out a high proportion of their profits as dividends, which kept their surpluses low.

Until 1776, when America declared its independence, Americans were prohibited under an act of Parliament from forming stock insurance companies. As a result, colonial merchants had to obtain their insurance through London, a somewhat difficult process in those days. Even when stock companies were finally allowed, their capacity was limited due to the shortage of capital in America. For example, Thomas Willing, a prominent Philadelphia underwriter and one of the city's richest merchants, had assets totaling just £10,000.

Between 1792 and 1800, thirty joint-stock insurance companies were organized. Of these, three still survive. They are the Insurance Company of North America, the Insurance Company of the State of Pennsylvania (now owned by AIG and run by Jeffrey Greenberg, its president) and the Providence-Washington Insurance Company.

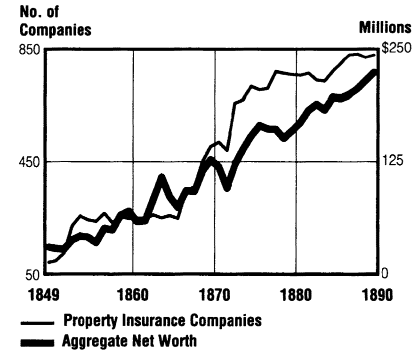
All but three of New York's insurance companies were bankrupted by the Great New York Fire of 1835.

Although the basic policy form was adapted from England, there was little standardization in terms or conditions. Policies were generally handwritten documents that described the property insured and the limit. They were individually underwritten, and both the insured and insurer relied on a mutual understanding of the terms. Risks were classified in the English manner, and sound slightly Monty Pythonesque: Common Insurances, Hazardous Insurances, Doubly Hazardous Insurances, and Special or Extraordinary Risks.

In the early nineteenth century little data were available to create rates that were actuarially sound, so insurers flew by the seat of their pants or used foreign rate tables, which weren't appropriate. Since insurance companies didn't really understand the concepts of probabilities and risk-spreading, they often made mistakes that jeopardized their companies.

The agency system started in 1807, when the Insurance Company of North America, which was then primarily a

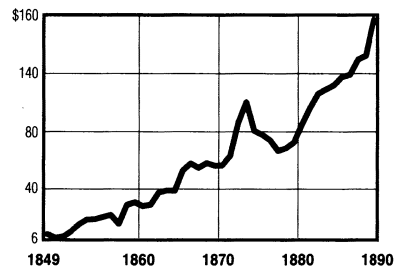
The Dawn of Property Insurance



Source: Donald Armstrong, *A History of Property Insurance Prior to 1890.*

Rapid Growth

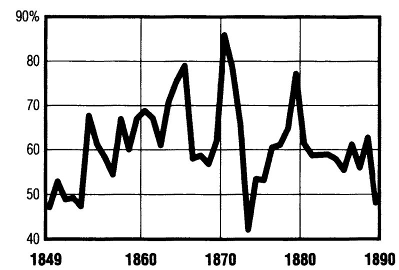
Property Insurance Premiums (Millions)



Source: Donald Armstrong, *A History of Property Insurance Prior to 1890.*

19th Century Insurance Cycle

Property Insurance Loss Ratio



Source: Donald Armstrong, *A History of Property Insurance Prior to 1890.*

marine insurer, appointed it first fire insurance agent. At that time, the company had $700,000 of assets, of which 46.4% was in treasury bonds, 28.6% in notes, and 25% in stocks of toll roads, bridges, and canals. Records indicate that the Hartford Fire Insurance Company paid its agents in Middlebury, Vermont a commission of fifty cents per policy in instances where the limit was greater than $1,000. By 1823, the standard commission was 5%; by 1830, it was 10%.

By 1824, there were at least seventy-four fire or marine insurance companies located in the major cities, with a combined capital of more than $25 million. Although New York State began imposing a 10% premium tax, regulation was minimal. In 1828, New York required that insurance companies submit an annual statement to the state comptroller.

All but three of New York's insurance companies were bankrupted by the Great New York Fire of 1835, which started in the Comstock & Andrews store on Pearl Street. Fanned by strong winds, it spread through lower Manhattan, destroying almost 600 buildings and causing $1 million in damages. The fire turned out to be something of a marketing boon for out-of town companies, however. When word of it reached Hartford, the president and secretary of the Hartford Fire Insurance Company immediately arranged bank loans, climbed in a horse-drawn sleigh and drove 108 miles through the snow to New York, where they set up an office to adjust and pay claims, which totaled $85,000. The goodwill gained by this extraordinary effort paid off during the next six months, when the Hartford took in $97,000 in new premiums in New York, five times as much as the previous year.

The early days of the fire insurance industry were marred by an assortment of sleazy promoters, speculators, and swindlers who were constantly organizing undercapitalized insurance companies. These often went broke, leaving a trail of burnt investors and—since there were no guaranty funds—unpaid claims. In addition to giving the industry a bad name, the competition from these marginal companies kept rates lower than they would have been, otherwise.

The first insurance brokers appeared on the scene in New York City after a large fire in 1845 further decimated the local insurance companies. Before then, there hadn't been much need for brokers' services: coverages were rudimentary and property insurance limits in excess of $100,000 were unheard of. But as the city grew, a number of enterprising businessmen induced a few of the local insurance companies to pay them a commission for bringing in business. Since most insurance companies operated directly or through agents, they wanted nothing to do with these upstarts, but by the late 1850s there

were about fifty of them in the city, and they were prospering.

"The Panic of 1857 caused many merchants to fail," said Cornelius DuBois—a partner in the brokerage of Frank & DuBois—in an address delivered fifty years later. "Being thrown out of business, something had to be done by their friends to provide for them. In this way, a number of additional insurance companies were started, for no other purpose than to give the Presidency to some merchant who had failed."

The brokerage business was also populated by assorted losers and misfits, according to DuBois. "Men who had been unsuccessful in other lines of business" joined the ranks of brokers because the business required no capital, and they wasted no time "importuning their friends to allow them to attend to their insurance." Professional licensing standards were almost nonexistent: to become registered as a broker one needed but two customers paying $2 in premium. Insurance companies didn't have to meet rigorous standards either, as states had only recently instituted the practice of examining them. In 1858, Massachusetts had only two full-time insurance examiners.

As the property insurance industry grew and began insuring risks throughout the country, independent agents began to exert greater control over the risks they wrote, which forced insurance companies to compete for the agents' business. This lead to upward pressure on commission rates and downward pressure on premiums. By the 1860s, agents had gained binding authority.

In 1862, when the New York Board of Insurance Brokers was formed, the business scene was primitive. The Atlantic Cable and the telephone didn't yet exist, nor did the universal practice of employing stenographers. The telegraph was just catching on and the widespread commercial use of electricity was more than a generation away. America was growing rapidly, however, and the expansion of industry led to large private fortunes and concentration of values. This confluence of wealth and property created a demand for insurance, and—at least in the brokers' minds—a greater need for insurance brokers in New York City. The insurance companies, who viewed the broker as a greedy salesman looking for an easy buck, thought otherwise.

The war between the brokers and insurance companies culminated in 1868 with the distribution of a circular signed by twenty-six insurance companies. It read in part: "The insurance brokerage system is, in the judgment of the undersigned, an evil to both Insurance Companies and their customers, with little compensating good." The brokers were blamed for an increase in the "voluntary destruction of property by fire" and for inducing insurance carriers to "accept risks of character so doubtful . . . that they should not be insured." The diatribe finally stated, "Customers can place their own insurance better than brokers can."

In 1866, seventy-five of the leading stock insurance companies banded together to fix prices.

The circular was a complete failure, and within forty years, nineteen of its twenty-six signees were out of business. Meanwhile, the brokers flourished. In 1874, there were 362 brokers and 147 insurance companies in New York City. By 1907, ninety-five of those insurance companies were out of business, but the brokers ranks had grown to 7,730. Agency forces grew rapidly, too. The Insurance Company of North America, for example, expanded from forty agents in 1860, to 1,300 in 1876.

By the end of the Civil War, the property insurance business was in a slump. Underwriters still had little idea of the appropriate rates for a given risk, and as a result were too eager to write business. In July 1866, seventy-five of the leading stock insurance companies organized the National Board of Fire Underwriters, in order to insure profitability. One recent book calls the Board's functions "a cooperative effort to mitigate the problems facing fire insurers" by attempting to "maintain a uniform system of rates, establish uniform commissions, combat arson, and devise solutions to common problems." In plain language, however, the Board was a price-fixing organization.

It worked for a while, but by 1870, the member companies went their own way and the inevitable rate cutting resumed. (The property insurance business was wildly cyclical during the nineteenth century. See chart on page four.) Two

The Insurance Boom: 1850-1890

	1850	1890	Increase
National Income	$2,609,000,000	$22,301,100,000	176%
Population	23,191,876	63,900,000	176
National Income (Per Capita)	$113	$349	209
Property Insurance Companies			
Cash Premiums	$6,021,256	$156,765,915	2503%
Losses Paid	3,186,600	75,687,997	2265
Net Income	1,935,885	31,514,098	1523
Insurance in Force	613,306,029	9,602,949,829	1464
Gross Assets	30,790,424	353,030,435	1043
Number of Companies	99	827	735
Net Assets	29,172,790	222,431,269	693
Paid-in Capital	14,509,998	97,911,835	574
Cash Dividends	1,326,001	7,540,733	468
Property Insurance Companies (Per Capita)			
Cash Premiums	$.26	$2.45	842%
Losses Paid	.14	1.18	743
Net Income	.08	.49	513
Insurance in Force	26.00	150.00	377
Gross Assets	1.33	5.51	217
Net Assets	1.26	3.48	176

Source: Donald Armstrong, *A History of Property Insurance Prior to 1890.*

major disasters in the next two years caused the market to firm, but not nearly as fast as one would have expected. The Chicago Fire of 1871 destroyed close to 20,000 buildings, caused $490 million of insured losses, and bankrupted sixty-eight of the 200 insurance companies that had written policies. It was followed by the Great Boston Fire of 1872, which caused $50 million of insured damage and the failure of twenty-two Massachusetts insurance companies and three New York insurance companies. The industry's loss ratios in 1871 and 1872—85.7% and 79.3%, respectively—were among the worst ever recorded. By 1874, when most insurance companies were once again under the auspices of the National Board of Fire Underwriters—it represented 95% of the industry's capital and 90% of premium—the loss ratio hit 42%, perhaps an all-time low. A few years later the rate cutting started again.

Although the Board was never able to achieve rate stability for any prolonged period, it successfully developed a standardized fire policy. Massachusetts was the first state to adopt it, in 1873, followed by Michigan in 1881, New Hampshire in 1885 and New York in 1887.

By the close of the nineteenth century, the insurance industry had evolved to the point of some sophistication. Other coverages were developed, including windstorm, tornado, earthquake, explosion, flood, water damage, sprinkler leakage, riot, and vandalism. Boiler and machinery insurance—devised by the Hartford Steam Boiler Inspection and Insurance Company—was available by 1866; fidelity and surety bonds by 1878; workers' compensation by 1887; and automobile collision by 1899. Fire insurance capacity was still severely limited, as reinsurance was not yet common, and large risks generally required policies from dozens of insurance companies. Rate regulation did not exist.

The chart on page six indicates just how rapidly the property insurance industry grew during the last half of the nineteenth century. Although the United States' population and national income increased 176% between 1850 and 1890, property insurance premiums increased 2,503%.

Those were the days. ■

Tobacco and Insurance

A Profitable Combo

Sometimes the best investments are the simplest ones. Such is the case, we believe, with Loews Corporation, in which we have recently invested. Loews' has two main businesses: Lorillard, which produces Newport and Kent cigarettes, and CNA Financial, the top-notch insurance group. Over time, both (although especially Lorillard) have grown nicely, earned good returns, and generated significant cash flow. Loews also owns Bulova, Loews Hotels, Diamond M and ODECO (oil drilling), 22.9% of CBS, 16.3% of Champion (paper and forest products) and various other investments.

At first glance, Loews' attractions are obvious: earnings and book value have compounded at a 19% rate over the past decade, and the balance sheet is conservative. At a recent price of $117, the stock is selling for less than nine times 1992's earnings and at a modest premium to book value. This snapshot understates Loews' true value, however, because CNA's earnings are depressed, and a variety of others assets are reflected only on the balance sheet.

Based on our calculations, Loews sells at a 33% discount to a conservative valuation of the sum of its parts. (See chart.) For every share of Loews, one gets .79 shares of CNA worth $74; .05 shares of CBS worth $9.85; and a bunch of other assets worth $7.80. The total: $91.65, which doesn't include Loews' most profitable business, Lorillard, which will earn $540 million after taxes. In other words, at $117 a share, one is getting Lorillard for $25.35 ($117 minus $91.65), about three times earnings. Using a multiple of ten times earnings, which we think is conservative, we come up with a value of $83 per share.

When we went through these numbers for a stockbroker friend of ours, his first comment was "You can't buy many shares of a $117 stock." That's a little like Yogi Berra's response when the waiter at the pizza parlor asked him whether he'd like his pizza cut into four slices or eight: "Better cut it into four," said Yogi. "I don't think I can eat eight."

The stockbroker then said that obviously the stock was cheap but that he didn't know why it would go up. Our reply? We never know why stocks go up or down; we just know a good deal when we see one. ■

Loew's Corporation: Selling at a Big Discount

Division	Value (per share of Loews)	Value ($ Millions)
Lorillard Kent and Newport cigarettes. Incredibly profitable cash cow. Earnings continue to rise as price increases have more than offset reduced volume. Net income should be about $540 in 1992. Conservative valuations: ten times earnings.	**$83**	**$5,395**
CNA Financial Loews owns 83% of this insurance group. (For every share of Loews, one gets .79 shares of CNA.) Although earnings are currently depressed, over time this well-reserved, conservatively managed company earns adequate returns. Although "private market value" is considerably higher, our valuation is based on the recent stock price of $93 (which approximates adjusted book value.)	74	4,810
CBS Loews owns 22.9%. (For every share of Loews, one gets .05 shares of CBS.) Current stock price: $197.	9.85	640
Other Assets Loews Hotels, Bulova, Diamond M and ODECO (oil drilling), 16.3% of Champion etc. Valuation: estimated book value.	7.80	507
TOTAL	$174.65	$11,352

65 million shares outstanding. The Tisch family controls 26%.

Equitable Revisited

Our September 1992 issue included a blunt assessment of The Equitable Companies. We cast a skeptical eye on its mortgages and real estate investments and wondered whether the reserves on these were adequate, and why they were lower than Travelers'.

Shortly after the issue was published, we received a phone call from Gregory Wilcox, who, in addition to being senior vice president of the Equitable, is in charge of investor relations. Not surprisingly, he wasn't thrilled by our point of view, although he admitted we had our facts straight. His main beef: we hadn't presented a "balanced" picture. (We disagree.) Among Wilcox's points were the following: 1) Equitable's real estate experience has been very good over a long period of time (until recently). 2) Equitable is the largest manager of real estate for third parties and is acknowledged to be a real pro. 3) Unlike Travelers, which got most of its bum real estate through foreclosure, 82% of Equitable's real estate was purchased. (While this may be a dubious distinction, at least Equitable stood to gain an equity return.)

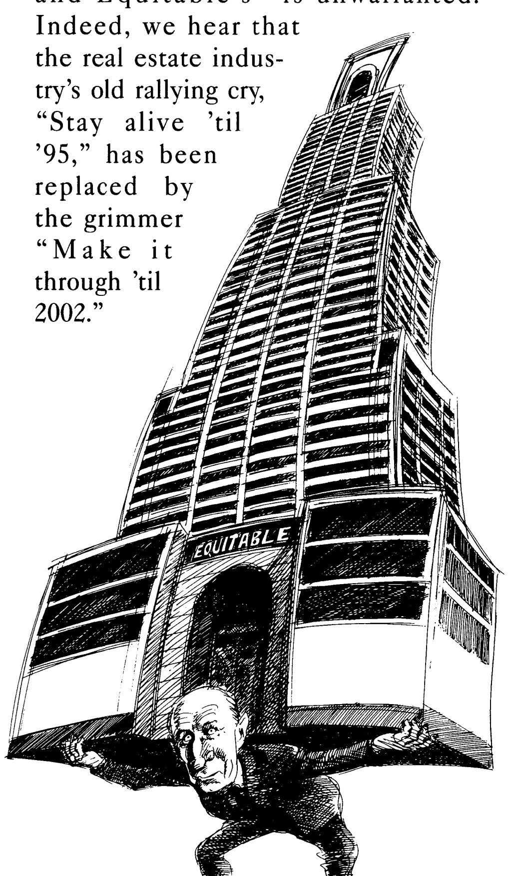
Wilcox also told us that Equitable's reserves, as a percentage of "problems," are among the highest in the industry. (Their percentage of real-estate related investments are also among the highest in the industry.) He felt that with the public offering of stock, mortgage prepayments, and the new management team, the company is in good shape. To prove it, he sent a detailed financial supplement—"more disclosure than anyone else gives"—along with a note: "As you can tell, we disclose our warts as well as our good points. While balanced disclosure may not change a reader's final opinion; it does give the reader the opportunity to form his own opinion."

We decided to spare our readers, and not reprint the 124-page supplement. We're also foregoing the debate whether Equitable is adequately reserved, since that is inherently unknowable right now. Instead, we will turn our attention to the Prime Property Fund—Equitable's "flagship portfolio"—a $3.3 billion real-estate mutual fund with 211 investments.

Started in 1973, the Fund, which is carried on Equitable's balance sheet as a "separate account," reported good returns until the end of 1989. After that things went downhill fast, despite the investments in buildings of "indisputable quality." In 1990, the total return was .4%. In 1991, it was –7.2%.

These results are considerably worse than those reported by Equitable on its own real estate. Why? Because the Fund has marked its portfolio to market "with unflinching appraisals that are reflective of current realities," something Equitable has definitely not done, nor is it required to do. The Fund admits that the current real estate environment has been the worst since the Great Depression, but also believes there are signs of firming in the office market, the hardest hit sector. Still, they are resigned to waiting until mid-decade for office rent increases.

It seems like the Fund's optimism—and Equitable's—is unwarranted. Indeed, we hear that the real estate industry's old rallying cry, "Stay alive 'til '95," has been replaced by the grimmer "Make it through 'til 2002."



Richard Jenrette, Chairman of The Equitable Companies.

Why would real estate be so bad for so long? Supply and demand. Even if the economy turns, the vast real estate overcapacity, which acts as a ball and chain around the industry's neck, won't be soaked up anytime soon. When leases expire during periods of excess supply, they are renewed at lower rents, not higher ones. As the 1980s' high-priced leases come up for renewal in the 1990s, many real estate owners will find themselves squeezed. This drawn-out process lasts a lot longer than a recession; it ends when supply is whittled down. There's a decade's worth of office space in many markets, and vacancy rates are close to 20%, so optimism seems premature.

Wilcox has an answer for that. Referring to their owned real estate (not that on which they've made mortgages) he says: "We have ten to fifteen year leases, so when we're rolling rents it's not so bad. In 1993, only 6% of our space comes up for renewal." Still, between now and 1996, one-third of all leases come due.

But what if Equitable marked-to-market its own portfolios—as the Fund has done? Admits Wilcox, "If we had to liquidate there's no question that in today's market we'd take a hit." His contention, however, is that Equitable will not be a forced seller, and that over time, values will rise. He said that Equitable's 16% vacancy rate, while no thrill, is 3% better than the national average, and that the 20% reserve on problem mortgages has been adequate, so far. "Here's a problem with the industry," he explains. "We're in the business of writing long-term liabilities: ten, twenty, forty years. We try to match these liabilities with long-term assets. Over the long term you go through cycles," he added, referring to bull and bear markets, inflation, deflation, high interest rates, and so on. "But what could one do to avoid the potential mark-to-market problem?" he asked hypothetically. "You could invest short term—where assets are marked-to-market every day. But then you have a mismatch."

We agree that investing short term is not the answer, although mediocre shorter-term investments are clearly preferable to bad longer-term investments.

While Wilcox conceded being forced to liquidate or unwind long-term assets at the wrong time would cause a problem, he pointed out that "rarely are companies forced to liquidate. Rarely are there runs."

That's certainly been true, Executive Life and Mutual Benefit notwithstanding. Even during the Depression there weren't runs on the major life insurance companies. (At year end 1932, policy loans comprised 21% of Equitable's assets, versus 11% today. On the other hand, in 1932, 83% of mortgage principal payments due were paid, versus just 13% in 1992.) Whether widespread runs would have occurred in 1933 will never be known, because on March 9 of that year, the insurance commissioners of most states, including New York, declared a "moratorium" on policy loans and payments of surrender values. In most states, this moratorium lasted long after the Bank Holiday had ended.

Today, information travels much faster and policyholders won't sit tight in weak companies. The run risk is probably greater than at any time in the last sixty years.

Wilcox assured us that Equitable is working hard to be efficient. "There's a new culture here. A new team. A new discipline." Obviously, Equitable hasn't replaced all of its people or even changed its 8,300 person career agency force, but a number of folks at the top, including CEO Richard Jenrette and president Joseph Melone, aren't part of the old guard that caused the problems. Wilcox, too, is new, and we asked him why he came to Equitable. "I came because of Richard Jenrette. I thought this was a noble cause—an historical event—and I wanted to be part of it."

But can Equitable achieve a good return on equity? "Yes!" says Wilcox. "The bigger you are the easier it is. It's an economy of scale business. With the smaller spreads and more complex products these days, anything under $3 billion in assets is too small." (Equitable has $146 billion in assets under management.)

Wilcox foresees a lot of consolidation in the life insurance industry, but thinks small companies can succeed if they're regionally focused or a niche specialist. He thinks more companies will demutualize—as Equitable has done—but says the "demutualization laws are cumbersome and expensive."

Because Equitable competes with other giant life insurance companies, most of which are rated higher, it's at a disadvantage. Policyholders should demand a higher yield or lower premium from Equitable than from higher-rated insurance companies. This hurts profits, which makes it tougher to strengthen the balance sheet. Equitable has Best's fourth highest rating, A–. In relative terms, this isn't good. Of the 797 companies receiving a letter rating, 481, or 60%, were rated higher than Equitable. Only 261 companies, or 32%, were rated lower.

Although Equitable still has many problems, it's probably fair to say that even though it's rated A- for safety, it deserves an A++ for effort. Jenrette and his team are trying to shake up the company, and maybe the system. As Wilcox told us, "Life insurance has always been marketing driven. At Equitable, we're finance driven." That's strikes us as a good idea, but it's not clear whether it will work, because Equitable is starting at a disadvantage. The party line, though, is that the company will make money in 1993. Just how much, they aren't saying. *(Continued on page 10.)*

(Continued from page 9.)

Even if Equitable is a smashing success, Richard Jenrette and other company officers won't profit from it. That's because officers were prohibited by the insurance department, as part of the demutualization plan, from buying stock in the company for two years. Rightly or wrongly, Equitable's management is confident and would have put their money where their mouth is. And Equitable certainly could have used that extra money.

But that's the way it is with insurance departments. They don't prevent companies from getting into trouble, and then they hinder their efforts to get out of trouble. Go figure. ■

New York DBL

A Better Way

There are now more insurance companies actively writing DBL than at any time in recent memory. The significance of this is something we've said many times before: because no insurance company—not even the best—can come through for you all the time, you can't afford to limit yourself to a handful of DBL carriers. Since Emerson, Reid's expertise, personnel, market share, number of markets, and competitive posture is unrivaled, we think it makes good sense to do business with us. ■

Long Term Disability

Product For The '90s

Demand for Long Term Disability has been growing rapidly. Still, only 27% of American income earners have any form of coverage, while 85% have health insurance.

Although most working people have a much greater chance of becoming disabled than dying—a thirty-two year old is 6½ times more likely to be disabled for ninety days than to die—life insurance is much more prevalent.

Eventually, Long Term Disability will be almost as common as health insurance is, 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, too. So you might as well give us a call. ■

Statutory Disability Plans

	California (SDI)	Hawaii (TDI)	New Jersey (TDB)	New York (DBL)	Puerto Rico (TDI)	Rhode Island
Coverage Provided By	Private Carrier State Self-insurance	Private Carrier State Self-insurance	Private Carrier State Self-insurance	Private Carrier State Self-insurance	Private Carrier State Self-insurance	State
Benefit	\$50 to \$336 per week depending upon the benefit schedule.	58% of the average weekly wage up to a maximum of \$307. The minimum is \$26 or average weekly wage, whichever is less.	66⅔%of the average weekly wage up to a maximum of \$304 per week.	50% of the average weekly wage up to a maximum of \$170 per week.	\$12 to \$113 per week for non-agricultural employees. \$12 to \$55 per week for agricultural employees.	60% of the average weekly wage to a maximum of \$374 per week.
Duration of Coverage	52 Weeks	26 Weeks	26 Weeks	26 Weeks	26 Weeks	30 Weeks
Date When Disability Benefits Begin	Benefits begin on the eighth day of disability or the first day in the hospital, if earlier. If an employee is disabled for fourteen days, benefits are retroactive to the first day of disability.	Eighth day of disability.	Eighth day of disability. If employee is disabled for three consecutive weeks following the waiting period, benefits are retroactive to the first day of disability.	Eighth day of disability.	Eighth day of disability, or the first day in hospital, if earlier.	Eighth day of disability. The waiting period doesn't apply if the disability extends beyond 28 days or if the employee is on unemployment.
Employee Cost	1.3% of the first \$31,767 of annual wages.	The lesser of 50% of premium or ½% of weekly taxable wages per person up to \$528.17.	½% of the first \$16,100 of annual wages per person.	½% of covered payroll up to a maximum of 60¢ per week.	30¢ per \$100 of weekly wages up to a maximum of \$9,000 per year.	1.3% of the first \$38,000 of wages.
Employer Cost	None.	The rest of the cost.	Based on a factor assigned by experience, not exceeding ¾% of the first \$16,100 of annual wages.	The rest of the cost.	The same as the employee.	None.

LETTERS TO THE EDITOR

We ran this cartoon in our June 1990 issue, but it only recently occurred to us that Messrs. Buffet and Greenberg might like a print of the original artwork. Their replies to our offer are printed below.

AIG's Hank Greenberg and Berkshire Hathaway's Warren Buffet discuss the finer points of the insurance marketplace while top insurance industry executives look on.

I would like to take you up on both your offers: an enlargement of the illustration of me and Hank Greenberg as well as a subscription to the newsletter. Maybe in the future you could have another cartoon that illustrates how the arm wrestling contest came out.

Thanks for thinking of me.

Warren Buffet
Omaha, Nebraska

Thank you very much for your letter and the newsletter. Indeed, I have never seen the caricature before. I would be delighted to have a larger print and would be honored to be on your mailing list for the newsletter.

I am very pleased to hear about Schiff Terhune. *[Editor's note: Emerson, Reid's president, David Schiff, is the great-grandson of Schiff Terhune's founder.]* It was a great brokerage firm with a great history, and I am pleased that there is continuity.

Many thanks for thinking of me.

Maurice "Hank" Greenberg, Chairman
American International Group, Inc.
New York, New York

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, NY 10019.

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

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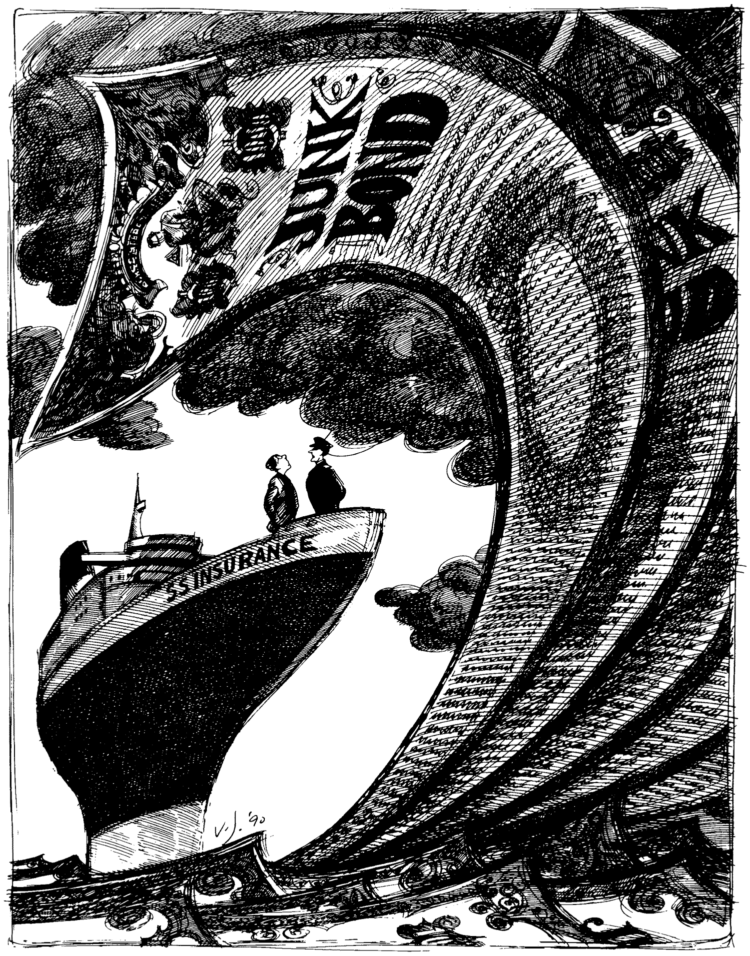

"My insurance company? Why do you ask?"

In 1989, when we warned about the problems junk bonds could cause, some people thought we were just kidding.

Emerson, Reid's Insurance Observer isn't like other insurance publications. For starters, it's entertaining. We do our best to be irreverant, amusing and on the cutting edge.

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

We analyze the insurance scene and tell you what's really happening. BEFORE it happens. For example:

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

There's more. Much more. So subscribe now (subscriptions are complimentary to brokers and agents) and discover why *Emerson, Reid's Insurance Observer* has become the newsletter that insurance people actually enjoy reading.

☐ **Yes, I'm a broker or agent. Please send me a complimentary subscription. (For all others it's $30.)**

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EMERSON, REID'S
INSURANCE OBSERVER

10 Columbus Circle, New York, NY 10019
Telephone (212) 765-2103 FAX (212) 246-0876

Emerson, Reid's Insurance Observer is published by Emerson, Reid & Company, Inc., the leading General Agent, Intermediary and Specialist in New York DBL.