EMERSON, REID'S

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It's a Barnum & Bailey World

The Insurance Industry Is Consolidating. So What?

In order to reign in expenses, the property-casualty industry has, in recent years, done what it has always been loath to do: downsize. For example, tradition-bound Lloyd's of London, which has been losing both money and "names" at an alarming rate, recently fired its two "chairman's waiters." These fellows, whose jobs entailed dressing in blue-and-red tailcoats with silver buttons, were as expendable as the chairman's Rolls Royce, also gone, as is the old chairman. Gone too is fifty percent of Lloyd's underwriting capacity, which currently stands at $13.6 billion.

On this side of the Atlantic, where about ten percent of the property-casualty industry's workforce of 550,000 has been terminated, business has been bad, although the rally in insurance stocks would indicate otherwise. If you are an agent, broker, or underwriter, it hasn't been easy. You know—or should know—that the market is soft, that the industry is underreserved by at least $30-50 billion (the industry's surplus is about $160 billion) and that the bond market can't be an eternal source of long-term gains for insurers.

Reliance Group's Chairman, Saul Steinberg, collects his $6 million salary.

If you are Robert Steinberg, president of Reliance Group and brother of six-million-dollar-man Saul, you have told *Best's Review* that the industry will experience widespread consolidation because it has "too much capital"—an ironic observation coming from the president of a company lacking the wherewithal to garner an "A" rating. Steinberg explained that the surfeit of capital currently depressing the industry's return on equity would ultimately result in capital leaving the insurance industry in search of a higher yield. While that makes sense in theory, it hasn't been the experience in the past. Low returns do tend to force the marginal insurance companies out of the business, increasing the returns for the remaining companies—in the short term. But these higher returns then act as a magnet for new capital. In good times the insurance industry has always attracted folks who think that they can do a better job underwriting, investing, or both. Right now, speculators—mutual funds, pensions, IRAs—are stepping up to the table and betting that insurance companies that have

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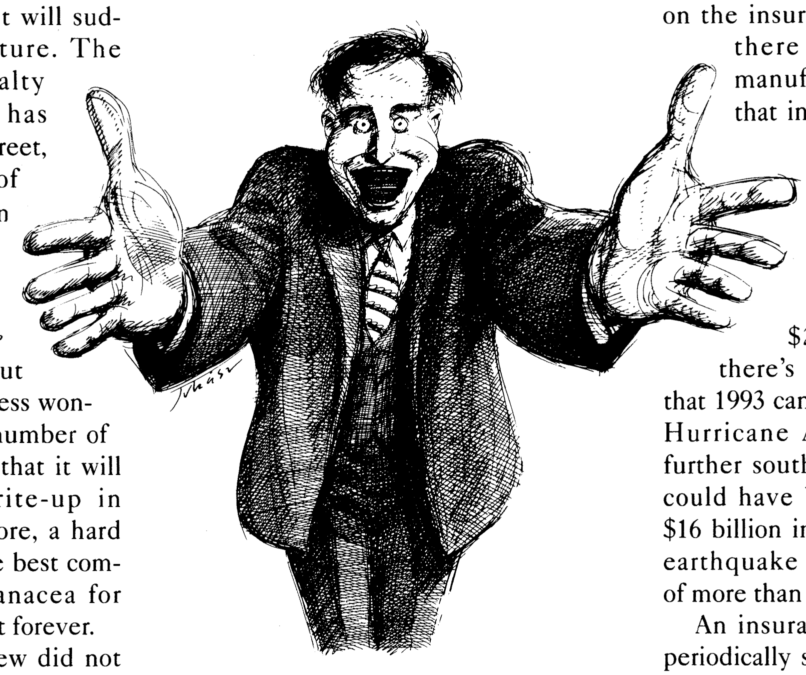
performed poorly in the past will suddenly do better in the future. The notion that property-casualty rates are heading north has become accepted on Wall Street, even though confirmation of that is not yet evident on John Street.

We also believe the bottom has been reached (*Emerson, Reid's Insurance Observer*, September 1992) but think a hard market may be less wonderful than expected, for a number of reasons, not the least being that it will be accompanied by a write-up in reserves. As we've said before, a hard market might be good for the best companies, but it will be no panacea for weak ones. Also, it won't last forever.

Our skeptical point of view did not prevent American Re from making its debut on the New York Stock Exchange in late January. Demand for shares was so great that the size of the offering, as well as the price, was increased. All told, the company raised $413.5 million, and the stock, which came out at $31, quickly surged to a thirty-percent premium.

At $31, American Re was selling at four times tangible book value and three times what leveraged-buyout mavens Kohlberg, Kravis, Roberts & Company had paid five months earlier when they bought the company from Aetna Life & Casualty. Perhaps it's foolish to attempt to make sense of this; perhaps all one really needs to know is what stockbrokers were undoubtedly telling their clients: it's a bull market and the stock is moving up.



"Take American Re. Please."

American Re went public at four times book value and three times what Kohlberg, Kravis paid five months earlier.

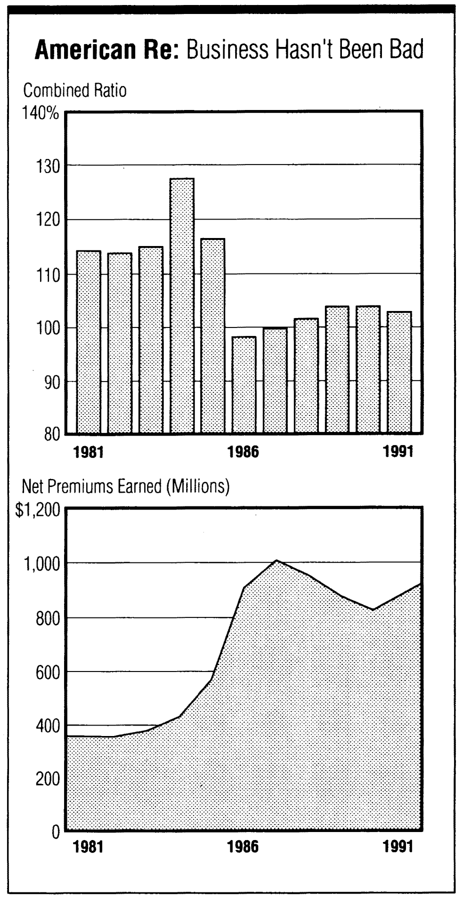
Although we like owning the shares of well-managed insurance companies, we prefer buying when they're out of favor. While we may well be in the upswing of the insurance cycle, insurance stocks are no longer cheap. But, as long as the window stays open, expect to see insurance companies continuing to raise capital through the sale of shares.

As for Mr. Steinberg's theory, even if consolidation occurs within the property-casualty industry—and it probably will—it's unlikely that competition will be any less intense. Although there are 3,900 active property-casualty insurance companies in America, the 250 largest account for about ninety-five percent of all premiums written. Even if ninety percent of the insurance companies in America were to disappear through merger, acquisition, or even liquidation, it shouldn't have a meaningful impact on the insurance buyer. The fact that there are only three U.S. car manufacturers hasn't prevented that industry from being intensely competitive.

Despite the glut of capital weighing upon the industry, things could be worse. Although 1992's catastrophe losses of $22 billion were a record, there's no law of nature that says that 1993 can't be another record. Had Hurricane Andrew hit twenty miles further south, for example, the losses could have been more than twice the $16 billion incurred. A large California earthquake could cause insured losses of more than $50 billion.

An insurance broker we know who periodically shares his thoughts with us (but prefers not to be mentioned by name) recently told us that the market is "if anything, more competitive." He said he sees no signs—not even a glimmer—of an upturn in the primary market, and says that he's finally given up predicting such things.

Although we didn't ask, we've got a feeling he's not buying American Re. ■



EMERSON, REID'S
INSURANCE OBSERVER

David Schiff, Editor and Writer

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KOSHER INSURANCE

From This You Make a Living?

WHEN ONE THINKS of the venerable Atlantic Mutual Insurance Company, whose roots trace back to 1824, the image of Jews observing the dietary laws is not what comes to mind. In fact, one suspects that Atlantic's company cafeteria has nary a kosher dish on the menu. Nonetheless, commerce being what it is, it's the Atlantic Mutual—and not, let's say, the Maccabee Mutual—that has recently come to market with a new form of coverage that indemnifies food processors for losses arising from an occurrence that causes kosher food to become non-kosher.

According to *Kosher Business* ("the independent news source for the kosher industry") Atlantic's kosher endorsement is an industry first. As we understand it, the policy language is simple: "The causes of loss are extended to include contamination of kosher food by non-kosher products."

Susan R. Harris, marketing manager for the Atlantic Mutual, downplayed the significance of the endorsement. "Since we already provide coverage for adulteration, spoilage, and changes in temperature and humidity, it really is just a slight extension or clarification of what we're already doing."

While that may just be true, the fellow who dreamed up the coverage, Michael R. Schechner of Schechner, Lifson & Chodorcoff, a Milburn, New Jersey agency, thinks it's a nifty feature and expects a good reception in the marketplace.

It should be stressed that kosher insurance is strictly a property coverage, and it doesn't cover loss of income or the cost of recall. Schechner hopes that those coverages, as well as third-party liability, will be available sometime in the not-too-distant future.

So how was it that Schechner, who keeps kosher, has an MBA from Wharton, and is the fifth generation of his family in the insurance business, came up with the idea for this coverage?

"Sometimes I just think of interesting things," he said. ■

Workers' Compensation State Funds

Disasters Waiting to Happen?

We all know it's prudent for an insurance company to keep a reasonable amount of surplus on hand to meet contingencies such as adverse loss experience, catastrophes, underreserving, or bad investments. Companies with only a thin slice of surplus have a much greater likelihood of getting into trouble and going down the tubes than do well-capitalized companies.

One indicator of surplus adequacy is a company's loss-reserves-to-surplus ratio: how many dollars of loss reserves it has for every dollar of surplus. The higher the ratio, the more leveraged the company is. In the long-tailed commercial liability business, a loss-reserves-to-surplus ratio in excess of 300% is considered to be, according to *Best's*, "above the accepted norm." This is just a general rule, and rules, as we all know, are made to be broken.

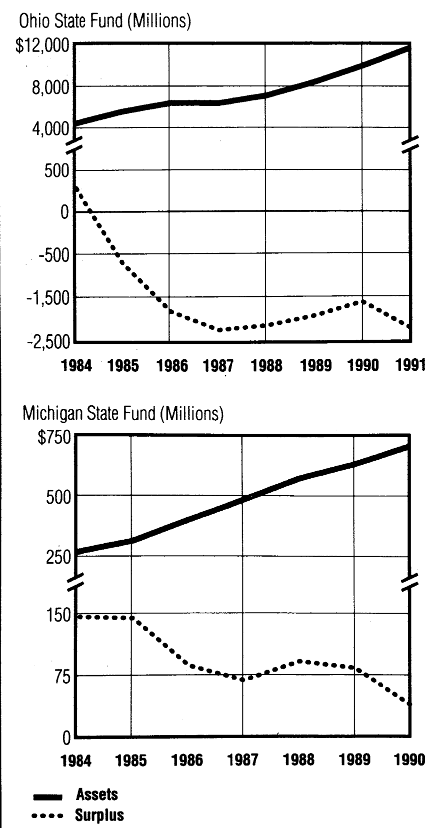
Therefore, it probably won't surprise you that there's a group of insurance organizations that takes this stodgy, old-fashioned notion and throws it to the wind. For these companies, ratios of 400%, 600%, 1,000% or even higher are nothing if not ordinary. As a group, these companies don't give a damn about shareholders, for they have none, and they profess to be unconcerned about profits, too, because that is not their mission. Who, you may ask, would be crazy enough to run an insurance company in this manner? Perhaps no one other than the government.

In the past we have chronicled the sorry tale of the New York State Workers' Compensation Insurance Fund—how it has been raided by New York State, how its books have been jiggered through the discounting of its reserves, and how the only thing standing between it and insolvency is a $1.3 billion non-interest bearing IOU from the state.

It would be nice if this sort of state-sponsored State Fund skullduggery were an isolated incident. That, however, is not the case. As of year end 1991, there were state funds in at least eighteen other states (Texas, New Mexico and Rhode Island established state funds in 1992) and the results of most can be described as nothing short of shocking. At least eight are insolvent (according to the Alliance of American Insurers) and several others are teetering on the edge. The vast majority of these funds have reported significantly deteriorating financial conditions since 1984.

Although most of the funds' problems stem from adverse claims experience, at least two do not. The Minnesota State Fund, which was seized by the Minnesota Department of Commerce last year, was clobbered by its investments in Interest-Only mortgage-backed securities, the nitroglycerine of the fixed-income universe. And the Pennsylvania fund's weakened condition is primarily attributable to the $432 million sucked out of it by the Pennsylvania legislature.

More Assets, Less Surplus



In absolute terms, the biggest disaster is the Ohio fund, which is also the biggest state fund in the nation. With $11.68 billion in assets, the fund—which has a monopoly on the workers' comp biz in Ohio—is truly a behemoth; ranked by assets it is the seventh largest casualty company in America. Ohio's problem is simple: in the last five years its combined ratio has averaged a woeful 157.2, and as of year end 1991 its surplus was *minus* $2.2 billion. Annual premiums are in the neighborhood of $2 billion.

Acting Director Wes Trimble told *The Wall Street Journal* that sloppy claims handling was part of the problem. "We probably paid a bunch of claims that shouldn't have been paid," he said.

Ohio's fund is notable for sheer size, but in relative terms it's not in the worst shape of any state fund. That dubious distinction may belong to Montana's state fund. Although at first glance its financial condition appears no uglier than that of West Virginia, the West Virginia fund has a monopoly on workers' compensation insurance in its state. Should it choose to, it could jack rates sky high. (Of course, that wouldn't be popular, and politicians hate to do things that are unpopular.)

Since Montana's state fund must compete with private insurers (sort of—it has a *de facto* monopoly with about 75% market share) one assumes it can only get and retain business by being at least as cheap as private insurers. Therefore, raising rates may not be the solution.

At year end 1990, the Big Sky State's fund had surplus of *minus* $221 million, which is about $275 per each of the 803,000 people living in Montana. This deficit is especially large considering that the fund only wrote $94 million in premiums and had $103 million of assets.

The Montana fund was reorganized in 1991, and for at least a moment was solvent. The "old" liabilities were separated and will be paid off through a payroll tax. Still, James Murphy, the executive vice president, says the fund "continues to experience difficulties." As of recently, the surplus was once again negative, to the tune of $42 million, even though rates have been raised sixty-five percent in the last year and a half. "Frankly, the system got out of control," he explained. "Private insurers aren't going to come back to the state."

Roger K. Kenney, Director, Actuarial Studies, at the Alliance of American Insurers, is a critic of state funds. Although the Alliance, which represents 170 insurance companies, can hardly be considered an unbiased observer, Kenney's observations seem on target. His report, *Workers' Compensation State Funds: Disappearing Capital*, chronicled the funds' declining surplus and increasing leverage from 1984 to 1991. Although Kenney thinks "a lot of [state funds] will continue to stumble along and meet their obligations," he is concerned about their dicey financials. "In a number of cases the situation will get worse," he told us.

Perhaps the biggest cause of the funds' problems is that they must react to political pressures. Kenney especially disapproves of the funds' weak finances that have resulted in a state bailout, because state funds "are being promoted as self-sustaining agencies."

To improve their appearances, many funds now discount their loss reserves, something done by few private insurers. This gives "a false sense of security," said Kenney. While discounting can give a more accurate picture of the value of claims to be paid over time, it is inherently less conservative, especially since many of the funds are underreserved and have so little surplus.

Although Kenney's report noted that eight state funds are insolvent (their liabilities exceed their assets), Jerry LeCompte, director of Arizona's State Fund and spokesman for the American Association of State Compensation Insurance Funds (AASCIF), doesn't think the sky is falling. Last year he told *The Wall Street Journal*, "We don't measure solvency in the same manner they do."

The AASCIF strongly disagrees with Kenney's report. A rebuttal entitled *State Compensation Insurance Funds: Still The Best Alternative*, explains that the state funds' mission is to provide "a ready and stable market for workers' compensation at the lowest possible cost." The AASCIF says that "state funds are different," that they operate on "zero-margin." In their arcane governmental world, having no surplus—or having a negative surplus—isn't seen as a problem, even though no insurance department would allow private insurance companies to operate in that condition.

The Best Alternative also argues that monopolistic funds operate under "unique circumstances," and that "surplus deficits do not stop [them] from writing insurance." Clearly, that has been the case. But how long can something continue to operate at a deficit? If you're the government, the answer is, pretty long.

So where will the money come from? Where it always comes from. Somewhere down the road the funds will assess employers, or raise taxes, or raise rates.

The real issue isn't whether state funds are better than private insurers, or vice versa; it's whether the situation is being managed prudently and being accounted for properly. Although state funds seem to have a definite cost advantage over private insurers—their expense ratios average 6.7 percent, less than half that of private carriers—they have done poorly. That's not surprising. Workers' compensation hasn't been a good line of business for anyone, and the state funds often act as insurers of last resort. But mostly, the problem is a political one—rates have been suppressed. Many funds have gone beyond their mandate of providing coverage at the *lowest* possible cost. They have provided coverage at an *impossibly* low cost. For example, West Virginia mandated a thirty-percent rate reduction in 1985, as well as a rate freeze through 1989. The results were horrifying. During that period the fund's surplus declined from $127 million to minus $404 million.

The state of Michigan may have found an intriguing solution for all this. It's putting its state fund up for sale. A variety of legislative details must still be plowed through, but the deal will probably be completed in the latter half of the year. Although the fund's results haven't been good—premiums and assets have grown rapidly but surplus has shrunk (see chart on page 4)—its fifteen-percent share of Michigan's voluntary workers' compensation market will apparently command a large premium to the fund's $47 million surplus. The sale is being conducted by Barclays deZoete Wedd, Inc., the investment banking arm of Barclays Bank, and based on what we hear, there are a number of parties interested in shelling out the $100 million+ asking price.

Good luck. ■

'A Gradual Accumulation Of Vulnerability'

Mutual Benefit in Rehabilitation

VICTOR PALMIERI, the Deputy Rehabilitator and Chief Executive Officer of Mutual Benefit, was the luncheon speaker at an Oppenheimer & Company life insurance conference held on January 20. Palmieri is what's known as a workout specialist: he cleans up other people's messes, such as the Penn Central and Baldwin United bankruptcies.

While his audience ate, Palmieri summed up the Mutual Benefit situation, calling it "extremely interesting, extremely complex" and ultimately "a human interest story." The size of the company—800,000 policyholders and thousands of employees—made its demise "a nightmare for the industry—a nightmare that couldn't have happened at a worse time."

Palmieri posed a question: was the former management of Mutual Benefit "stupid" or "blind" to the changes the industry was undergoing? His answer—"no"—was either charitable or just plain wrong. He explained that "convulsive changes in the environment had produced a fundamental shift in risk," which is true, but then blamed the "run" at Mutual Benefit on "an enterprising reporter at *The Wall Street Journal*" who wrote up the story of the company's horrible concentration of bad real estate and LBOs. "There had been a gradual accumulation of vulnerability," said Palmieri of Mutual Benefit's risky investments, then "a sudden change in environment." This prompted a flight from Mutual Benefit, for safety. "But for that," said Palmieri, "this company would still be operating."

Surely considerable blame must be placed on previous management, led by free-spending wheeler-dealer Henry Kates. Unquestionably, Mutual Benefit's ill-conceived, high-yield, high-risk investments violated the dictum laid down by former president Lewis Grover, who wrote in 1879 that "the strength of a life insurance company is not in the dimensions of its business, but in its capacity to give insurance with utmost safety and economy." The media didn't bust Mutual Benefit; its own management did.

Palmieri continued. The lesson to be learned from the Mutual Benefit situation, he said, is "how difficult it is to calibrate risk in a diversified financial organization." Ultimately, Mutual Benefit's fundamental problem was, and is, a "loss of value." Mutual Benefit has $8 billion in assets ($5 billion of which are in real estate) and $9 billion in liabilities. Right now, Mutual Benefit has a liquidating value of about fifty-five cents on the dollar. Virtually all the diminution in value is attributable to the real estate, which is worth about forty cents on the dollar.

Palmieri discussed the complexity of the restructuring process: "We had to reorganize a company in total disorganization. The entire senior management had been dismissed." Mutual Benefit had thirty-five subsidiaries, over one hundred joint ventures, and forty-four industrial revenue bonds outstanding, yet it had no cash-flow forecasting model.

Palmieri said that the reorganization plan, which wipes out Mutual Benefit's creditors, "is a true rehabilitation" with coverage for all. Obviously, how the deal works out very much depends on what happens with the company's real estate. Palmieri is hoping for a good break from the real estate market, but knows "it's not easy to predict."

The reorganization plan has not yet been approved, but speaking generally, Palmieri says, "We've come through a crisis. The industry is sound." He believes, however, that the result of the industry excesses will now be reflected in increased regulation. He warns: "We need more uniformity in state regulation, otherwise you'll see federal regulation....The industry needs a lot more disclosure, just as a starting point. It must make its financials more transparent. We need sensitivity to interest rate changes rather than mark-to-market. Statutory accounting conventions are fundamentally archaic. " ■

Faulty Towers?

The New York Post's *'Savior,' Steven Hoffenberg, Has a Strange History in the Insurance Business*

THE BIG MEDIA STORY in New York City has been the sudden appearance of Steven Hoffenberg, chairman and controlling shareholder of Towers Financial, as the "savior" of *The New York Post.* The newspaper, which has lost hundreds of millions of dollars, was on the verge of shutting down when the unknown and unheralded Hoffenberg materialized, claiming he wanted to buy *The Post* for the "glory" of it. It would be hard to imagine a more unlikely figure. Indeed, in his *New York Post* column, Mike McAlary called Hoffenberg a "shady... Repo Man" who "looks and sounds like a snake oil salesman." Hoffenberg, whose business is collecting overdue bills, has had a career marred by lawsuits and tangles with regulatory agencies, and both he and his company have been sued by the SEC for using false financial statements to fraudulently sell hundreds of millions of dollars' worth of securities.

Despite the intense media scrutiny of the Hoffenberg–*New York Post* situation, the details of Towers Financial's involvement in the insurance business have not been reported, until now.

Perhaps the most curious episode involves the company's October 6, 1987 purchase, for $3.6 million, of eighty percent of United Diversified Corporation, a holding company for United Fire Insurance Company and Associated Life Insurance Company. In a *Wall Street Journal* article two months later, Richard R. Allen, United Fire's treasurer, said of his company's acquisition: "We went from Oldsmobiles to Mercedes. I was very elated and very proud."

Towers' 1987 10-K dated December 17, 1987 spoke of the company's plans to acquire more insurance companies and expand nationally. The document also stated the following: "Management... anticipates [that] liquidity will increase during the current fiscal year....In addition, through the acquisition of control of United Diversified Corporation, the use of additional assets has been acquired."

Assets held in regulated insurance subsidiaries are subject to many restrictions, and in United's case, it seems particularly unlikely that they would have provided liquidity to the parent company. Of course, owning an insurance company to control a large pool of cash is nothing new, but those who get into the insurance business for that reason alone often wind up in trouble.

It wasn't long before Towers did put some of United Fire's assets to "use." On November 23, 1987, it filed a 13-D with the SEC stating it intended to make a tender offer for control of Pan Am. The 13-D filing was made in the name of Towers Financial Corporation/United Fire Insurance Company. At the time Towers had a reported net worth of $5 million and owned just 100,000 of Pan Am's 140,000,000 shares (an investment worth about $350 thousand).

The reaction to the proposed tender was underwhelming. Towers lacked credibility as well as cash, but the press, perhaps flogged by the six public relations staffers Hoffenberg employed, gave the story considerable coverage.

NEW YORK POST

50¢

NY Post Owner Charged By SEC

Repo Man also owned insurance companies that went belly up

Hoffenberg's Towers Financial is once again in the insurance business, this time with a Barbados-based reinsurance company.

Towers never proceeded with the takeover, and began selling its Pan Am shares eight days after announcing the proposed tender offer.

So what was Hoffenberg's motive? Did he really expect to gain control of Pan Am? Or was it something else? One thing is certain: the offer thrust Towers into the spotlight and, according to Hoffenberg, generated hundreds of news stories. Kenneth Koock of M.H. Myerson Co., a market-maker in Towers' stock, told *The Wall Street Journal* that Towers' fifteen minutes of fame "probably helped" the company sell part of a $50 million private offering of two-year notes.

Towers never did expand its insurance operations, and, as a matter of fact, the United Diversified acquisition didn't go well, although one wouldn't have known it from reading Towers' 1988 and 1989 annual reports. In fact, Towers' 1989 annual report carried the insurance operation on the balance sheet at $3.37 million, down $230 thousand from 1988. Even though they represented about one-third of Towers' reported net worth, there was no mention of the insurance companies other than a footnote entitled "Subsequent Events" that said "Conclusion of [the United Diversified] transaction is being held in abeyance pending the finalization of certain regulatory matters." The financial statement was audited by an obscure CPA, Marvin E. Basson, and was dated September 15, 1989.

With this in mind, we should take note that United Fire Insurance and Associated Life Insurance were placed in conservatorship under the control of the Illinois Department of Insurance on July 29, 1988, and then placed in liquidation on March 3, 1989, *more than six months prior to the publication of Towers' 1989 annual report.* The July 1988 complaint for conservation alleges many regulatory violations, including: failure to keep the books properly, making unauthorized investments, and allowing certain securities to be transferred out of the state. According to the Illinois Department, the insurance companies' surplus was impaired by over $14 million.

None of this was mentioned in Towers' 1989 annual report.

For two years Towers' annual reports neglected to mention that its insurance subsidiaries had gone bankrupt.

When queried about this, Hoffenberg, who had been Chairman of both insurance companies, said, "We purchased them in conservatorship and moved for recision." But according to Daniel Guberman, Deputy Chief General Counsel for the Illinois Department of Insurance, the insurance companies were released from conservation shortly after Towers took control, and placed in conservatorship again the following year.

Regarding the amount the insolvent insurance companies were carried on the Towers' balance sheet, Hoffenberg claimed that money was being held in a special account, but wouldn't elaborate, saying, "You will write it inaccurately because there isn't full disclosure. We will sue you." He then added: "If I want to talk about crap—you are an illegitimate fraud." He didn't specify why there wasn't full disclosure.

That was not the first time Hoffenberg had used this sort of bully-boy approach. On August 8, 1990, during a brief conversation in which he evaded most questions, he launched into a broadside of invective. "I'm going to report you to the insurance department and you'll lose your license," he said. "I know where you live..."

The Hoffenberg style was also in evidence during a meeting with several *New York Post* reporters on January 25, 1992. Speaking of Mort Zuckerman, owner of the *Post's* rival, *The Daily News*, Hoffenberg was reported saying "Fuck Zuckerman. He's a blue-blood wannabe. I ain't aristocracy. I don't want to know from aristocracy. I'm a Brooklyn guy. I eat guys like Zuckerman for lunch."

A bit more information on the status of the insurance companies was provided in Towers' Form 10 filed with the Securities and Exchange Commission on July 19, 1991. As of June 30, 1990, they were carried on Towers' books at $2,805,500. It was also disclosed that Towers had sued the previous owners and that they had filed a counterclaim against Towers and Hoffenberg. Although Towers' lawsuit was instituted in 1987, it wasn't mentioned in the 1988 or 1989 annual reports.

In Towers' 1992 annual report it was finally disclosed that the insurance companies had been placed in receivership. The annual report also stated that Towers settled certain litigation arising out of this situation in 1992. The bottom line: Towers gave up control of the companies and incurred a loss of $6.3 million pretax, and $3.78 million after tax.

None of the foregoing—the bankruptcies, the SEC problems, the lawsuits—have prevented Towers from borrowing large sums of money. As of June 30, 1992 (the most recent period for which information is available), the company had a whopping $397 million of debt outstanding, virtually all of it in the form of notes that mature between November 1993 and May 1997. Towers' reported net worth is $25.4 million, although the SEC contends that it is really minus $130 million. It is difficult for an outsider to analyze Towers' assets, liabilities and earnings or even to put them into perspective because Towers' financial statements haven't provided the level of disclosure one would normally find. That alone is usually a red flag.

What is disclosed in Towers' 1992 annual report, however, is that Towers is once again in the insurance business. Hoffenberg's letter to shareholders said the company took steps "to establish itself as a serious contender in the property reinsurance industry." In 1991, Towers International Reinsurance Corporation was incorporated in Barbados. It has been capitalized with $20 million—$10 million in cash and $10 million in a note from Towers. According to the Barbados Supervisor of Insurance, the amount of disclosure required in that country is considerably less than in the United States, although all licensed companies must file a financial statement.

According to Towers' annual report, Towers Insurance Group "specializ[es] in property and casualty reinsurance," and "provides coverages for primary-risk and reinsurance from domestic and offshore companies." Towers believes that the "profound changes in the world economy...the evolution of the European common market, and the formation of cross-border insurance alliances...create opportunities for new entrants with a basic approach to sound underwriting." Towers says that "by entering the insurance industry as a reinsurer, [it] is able to join the world's most prominent insurance entities on a quota share basis." For the fiscal year ending June 30, 1992, Towers International Reinsurance's gross written premiums were $34,000.

Why would someone start an insurance company and then write so little business? An employee of Johnson & Higgins in Barbados, which manages Towers International Reinsurance, said he couldn't provide any further information unless authorized to do so by Towers Financial. Another employee said that Towers was a captive and only insured its parent's liabilities. Regardless, it is still highly unusual for a heavily indebted company with huge cash needs to put $10 million into an offshore insurance company. Even stranger, although the company reported more than $10.1 million in cash at both the beginning and end of the year, interest income on this was only $13,312, which works out to be a yield of a bit more than one-tenth of a percent.

But then, when it comes to Towers Financial, the unusual is the norm. ■

Lots of debt, not much equity: Towers Financial Corporation — June 30, 1992

Assets		**Liabilities**	
Accounts receivable	$624,747,547	Due to clients	$240,953,678
Cash	32,487,055	Notes payable	394,214,500
Other receivables	1,858,909	Other payables	11,029,860
Note receivable — officer	448,900	Deferred income	7,245,103
Property and equipment	17,215,214	Deferred income taxes	5,517,500
Security deposits	474,776	**Total Liabilities**	**$658,960,641**
Prepaid interest and expenses	5,267,634		
Intangible assets	1,941,608	**Shareholders' Equity**	**$25,481,002**
Total Assets	**$684,441,643**		

Florida Insurance Guaranty Association Gets a Loan

How It Went Hat in Hand to Borrow $470 Million After Hurricane Andrew

HURRICANE ANDREW, which was the largest insured catastrophe in history, did more than just devastate southern Florida, bankrupt nine insurance companies, and severely impact many others—it also busted the Florida Insurance Guaranty Association (FIGA). FIGA expects to shell out over $500 million to the more than 15,000 policyholders of the insolvent insurance companies. Unfortunately, FIGA, which gets its funds by assessing all licensed insurers in Florida, was about $470 million short of the amount needed. As a result, it had to borrow the money.

The mechanics of the deal are a little arcane: the city of Homestead, which was at the eye of the hurricane, issued $472.3 million of Special Insurance Assessment Revenue Bonds maturing between September 1993 and March 2003. The bonds are tax-free and were priced with yields ranging from 2.45 percent to 5.375 percent.

The credit behind the bonds is neither the city of Homestead nor the state of Florida, but a two-percent assessment to be made on insurance companies' net direct written premiums in the state of Florida. Based on current premium volumes, the assessment will bring in $70.5 million a year. This is a staggering annual sum considering that in the twenty years prior to 1992, the total assessments for this type of loss were $121.3 million.

In case these assessments somehow prove inadequate, the bonds are also backed by municipal bond insurance issued by the Municipal Bond Investors Assurance Corporation. The cost of the insurance is $4-4.5 million.

As the accompanying chart shows, most of the nine insolvent companies were small and of recent vintage. Only four of them had letter ratings from *Best's*, and of these, only two were rated "good" or "excellent." The insolvent companies' combined surplus of $43 million represented only a tiny percentage of the Florida market, yet the losses caused by their failures were huge. This clearly demonstrates the inequity in the current guaranty system, where the more prudent companies are penalized for the losses of the weak or reckless, and where assessments are based upon premium volume rather than the riskiness of a company's book of business or its financial condition.

One of the Florida Department of Insurance's important responsibilities is the review of insurance companies' quarterly and annual financial statements. This is supposed to "assure that an insurance company is maintaining minimum levels of capital and surplus sufficient to meet its financial obligations." With the benefit of hindsight, it's quite obvious that the Department made a costly mistake. ■

The Big Sleep: Insurance Companies Rendered Insolvent by Hurricane Andrew

Company	Best's Rating	Year Formed	Surplus (000)
First Southern Insurance	NA–5	1963	$2,363
Florida Fire & Casualty	NA–2	1987	1,386
Great Republic Insurance	B	1985	2,524
Guardian Property & Casualty	NA–3	1986	2,192
Insurance Company of Florida	C	1971	4,353
MCA Insurance Co.	A–	1929	23,971
NOVA Southern Insurance	NA–3	1987	1,966
Ocean Casualty Insurance	NA–3	1986	2,547
Regency Insurance Company	D	1984	1,418

Sources: FIGA, Best's

Medical Malpractice Insurance Association

More Voodoo Economics

EMPIRE BLUE CROSS and Blue Shield had a bit of a problem: money was going out of it a lot faster than it was coming in. The solution—raising rates—was simple and obvious. It was also unpopular.

Despite last-minute negotiations between the Cuomo administration and the Republican leaders in the State Senate, a plan to "bail out" the ailing health insurer did not materialize, and on December 31,1992, State Insurance Superintendent Salvatore Curiale granted the carrier rate increases averaging 25.5 percent.

Twelve days later, the State Senate unanimously passed a bill, one of whose provisions was the transfer of $150 million from the Medical Malpractice Insurance Association (MMIA) to Blue Cross and Blue Shield.

In the short term, it seems extremely convenient that large pools of assets, such as the MMIA, can be raided and stripped bare whenever necessary. In the long run, of course, the money may well need to be put back.

Long-tail liabilities Negative surplus

The MMIA is not, as many would like to believe, just some big fat sitting duck, loaded with extra funds. It is an insurance company with extremely long-tail liabilities. As of December 31,1991, it had nearly $1.2 billion of assets and more than $1.8 billion of liabilities. Surplus is minus-$630 million. However, if loss and loss adjustment reserves are discounted to take into consideration future investment income, using a rate of return of seven percent, surplus would jump into the positive territory, to $46.5 million.

When we checked in with Richard L. Martin, CPCU, MMIA's president and chief executive, he sounded like a man not unfamiliar with the political process. He explained that there really is no surplus at MMIA. "I doubt we made money in 1992," he said, "and it looks like the experience is getting worse. We're paying out more than we thought."

The $150 million transfer from MMIA, which technically speaking is a loan, isn't the first time the state has siphoned some money out of the association. In 1992, $60 million was taken, also as a loan.

While this $210 million is small potatoes compared to the $1.3 billion pinched from the State Workers' Compensation Insurance Fund, it's nonetheless real money—money that may have to be paid back.

So why would the state grab this pool of money?

The answer is simple: because it's there. ■

Medical Malpractice Insurance Association (000's omitted)

New York State's Modus Operandi: Steal from the poor and give to the poorer

Assets		Liabilities	
Bonds	$1,042,938	Loss reserves	$1,319,259
Stocks	10,521	Loss adjustment expenses	303,021
Short term securities & cash	100,367	Other	192,252
Total Investments	$1,153,827	Total Liabilities	$1,814,532
Other	29,992	**Policyholders' Surplus***	**($630,713)**
Total Assets	**$1,183,819**		

*If loss and loss adjustment expense reserves are discounted for future investment income using a rate of return of 7%, surplus would become positive by $46.5 million.

December 31, 1991

LETTERS TO THE EDITOR

YOUR *INSURANCE OBSERVER* is the best publication we get. We all look forward to each issue.

Paul Markowitz
Insurance Affiliates, Inc.
Somerville, New Jersey

REALLY ENJOYED YOUR December *Observer*. The Equitable article was outstanding follow-up. However, it was Mr. Greenberg's letter that prompted an old memory of Colonel Schiff. My father was the Naval Liaison in Lisbon in World War I. He always spoke highly of The Colonel. Schiff Terhune handled my father's insurance until he died in 1951. Forty-one years can quickly slip by.

Robert C. Merrill
Syosset, New York

I HAVE JUST RECEIVED my six back issues of *Emerson, Reid's Insurance Observer* and was thoroughly impressed. I don't know when I've enjoyed reading an insurance publication so much. You've created a terrific publication. Keep up the good work.

C. Stephen Wallman
Wallman Investment Counsel
Madison, Wisconsin

THE FIRST COPY that I have seen of your *Insurance Observer* just arrived today.

You have done a magnificent job in the December 1992 edition of covering several key areas of our industry with a lot more insight than I have seen in any of the national trade publications.

In addition to your current comments, I particularly enjoyed your article "Playing With Fire." In my office, I have a number of firemarks framed, and it is amazing the number of people in our industry who do not understand the significance of things that took place in our fledgling industry.

Finally, I am still astonished at the number of reasonably sophisticated individuals who have not figured out the issues that you have highlighted in the article on Equitable.

Best wishes for continued success.

William B. Stephenson, CPCU, CLU
President
Donald F. Smith & Associates
Lawrenceville, New Jersey

I HAVE TWICE NOW read *Emerson, Reid's Insurance Observer*, and I have thoroughly enjoyed the reading. It is straight forward, insightful, and humorous. But the aspect I appreciate most are your insights into the underpinnings of this industry, (specifically your last two cover stories). You cut right to the heart of the matter, with no detectable hedging of the commentary towards the interests of the insurance companies—a bold stroke for a broker!

Thanks for enjoyable reading.

David Lapin, Vice President
Aetna
Simsbury, Connecticut

I READ EACH ISSUE of the *Observer* and find the point of view correct and in some cases thought provoking.

Jeffrey H. Jennings, President
Clifton Brokerage Corporation
Greenwich, Connecticut

We welcome your comments, criticism, and suggestions, so please call or 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 let us know if you've got a good idea.

The insurance market was so soft that underwriters rushed to insure a burning building.

When we said the insurance market had been down so long that it looked like up, people didn't know whether to laugh or cry.

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

We don't try to report "the new." 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 and discover why *Emerson, Reid's Insurance Observer* has become the newsletter that insurance people actually enjoy reading.

☐ **Enclosed is my check for $30 for a one year subscription to your quarterly newsletter.**

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