EMERSON, REID'S INSURANCE OBSERVER

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An Insurance Industry Paradox

The Vision Thing

Mike Milken, the disgraced junk-bond impresario, was fond of saying that capital isn't scarce—it's vision that's scarce. Although the ebb and flow of money in the insurance business depends upon the vagaries of cycles and financial markets, an unprecedented tidal wave of capital is currently hitting the industry, especially in Bermuda. The big question, therefore, is whether a fleet of visionaries is riding this tsunami of funds.

In a recent editorial, *Business Insurance* answered affirmatively: "We have a hard time believing that the established, well-managed insurance industry players investing in the Bermuda facilities...will commit the same dumb mistakes" that insurers made in the 1970s and 1980s—namely, cutting rates to gain premium volume.

We agree. They won't make the *same* dumb mistakes—but they will undoubtedly make mistakes. As Thomas Dickson, senior vice president of Centre Re, noted recently, "The key to what happens to all the money in Bermuda is 'discipline.' Everybody has loads of it today, but we'll see what happens to it in the future."

"If that shmuck hits me once more, I'm filing a workers' compensation claim."

This is the insurance business, after all, and no one has a patent on good ideas. "Capital and information move around at blinding speeds," observes William Thiele, the president of North American Re. "Capital moves into a hard market and stamps it out."

Historically, that has been true: the insurance cycle turned because losses depleted capital, which caused insurance companies to raise rates, which generated profits, which then attracted new capital that, ultimately, forced rates back down.

This time around it's a bit different: investors (prompted by investment bankers) have *anticipated* the upturn in the cycle and have, en masse, tried to get in early. Their very actions, however, may have the effect of preempting any turn for the better in the insurance market. Since a hard market is the result of financial pain stemming from losses and a shortage of capital, it stands to reason that if insurance companies can replenish their capital by issuing new shares (as they have done recently) rather than by increasing profits, the market will stay soft—at least for a while.

If our analysis is correct, the $15 billion in new equity that's come into the insurance market over the last two years

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(see chart below) can't help but be a less than stellar investment, and can't help but have a depressing effect on insurance rates.

How can that be? What about all the catastrophes?

Although there have been extreme dislocations in certain sectors—coastal property, for example—these have been mitigated by several factors: most insurance companies are geographically diversified; they write many lines of coverage; and they have benefited from the huge drop in interest rates. (A big rise in interest rates, however, could cause far more damage to insurance company balance sheets than a hurricane or earthquake.)

Ira Malis, of the investment firm Alex, Brown & Sons, notes that even in 1992—the worst year for catastrophe losses—the industry's surplus actually grew by $5 billion, and it was up another $10 billion during the first half of 1993.

Like us, Malis has marveled at investors' "seemingly endless appetite for insurance paper," and has stated flatly, "there is no insurance company that *cannot* raise money right now—at a price." Although such easy access to capital is an aberration that is obviously unsustainable, we don't know when this speculative boom will end.

Common sense, however, would argue, sooner rather than later. ■

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You Want Deals? We Got Deals.

PartnerRe, Lutine Capital, and Reliance Group

In a piece entitled "Reinsurance Alchemy" (*Emerson, Reid's*, Autumn 1993), we examined two recently formed reinsurance companies—Zurich Reinsurance Centre and Mid Ocean Reinsurance—that had just gone public at prices way above book value and way above the prices that insiders had paid a few months earlier. Although both companies were run by top-notch folks, we were wary of their shares because the valuations seemed so excessive.

Even though these shares have since retreated rather sharply, these deals may go down as a milestone in the history of insurance finance simply because their promoters managed to take a wisp of an idea (writing reinsurance in Bermuda), hire a handful of people, and then sell the concept to the public for a huge profit.

But that's the sort of market it has been—the Street couldn't get enough of insurance companies. That's the hallmark of this insurance capital-raising boom—that virtually every strategy has found a taker. Thus, small companies are attractive niche players, big companies are the beneficiaries of the flight to size and safety, badly managed companies are restructuring candidates, weak companies are contrarian plays, and brand-new companies with no business whatsoever are attractive because, as PartnerRe Holdings' prospectus so elegantly put it, they are "unencumbered by issues of loss reserve adequacy." (Because they have written no premiums, they have no loss reserves. Hence, no loss reserve inadequacy.)

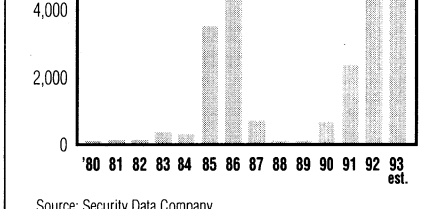
Although money has continued to flow into insurance companies at a torrid pace, judging by some of the most recent deals, the alchemy element of the equation has diminished somewhat. Funds are still plentiful (although that could end at any moment), but the markups to the public are smaller.

From the stack of prospectuses that we've taken a gander at, three new deals seem worth examining, not just for their size, but for their divergent business plans. They are PartnerRe Holdings, a recently formed Bermuda-based company that raised over $1 billion to write worldwide property catastrophe reinsurance; Lutine Capital, which will be a Corporate Member at Lloyd's; and Reliance Group Holdings, which issued $200 million of new shares and $650 million of debt.

PartnerRe Holdings Ltd. is perhaps the most notable, if only because it's probably the largest public offering of a start-up insurance company. Although the cover of the PartnerRe prospectus is emblazoned with a warning to investors—"THIS OFFERING INVOLVES A HIGH DEGREE OF RISK"—the deal was oversold. The lead underwriters were well known—Morgan Stanley, Smith Barney Shearson, and CS First Boston—but many of the lower-bracket underwriters were new to us—Doft & Co., Craigie Incorporated, and Foley Mufson Howe & Company. In all, a whopping seventy-six underwriters participated in the offering.

PartnerRe is sponsored by Swiss Re, which has agreed to allow PartnerRe to use its computer-based rating systems

The Gold Rush
Total amount of insurance stock offerings ($millions)



Source: Security Data Company

and historical database, and has invested $100 million for a ten-percent interest. Although Swiss Re bought its shares for slightly less than the public paid—$18.95 versus $20—it also received warrants that, based upon our rough calculations, had the effect of adjusting the true cost per share to $14. In other words, the public actually paid forty percent more per share than Swiss Re did. Head Partners, a merchant banking firm that co-sponsored the deal, did even better than Swiss Re.

PartnerRe intends to write property catastrophe and other non-casualty reinsurance on a worldwide basis. Like many others, it intends to take advantage of the worldwide imbalance between the supply of, and the demand for, property catastrophe reinsurance.

The company's strategy sounds familiar. It will operate through brokers, act as a lead underwriter, and not purchase reinsurance. It will try to manage its risks prudently, and yes, will write only business when it believes it can make an underwriting profit.

PartnerRe was formed in August 1993, and, at the time of the offering, had only hired a handful of people and not yet rented office space.

In a report published in October, Ira Malis, of Alex, Brown & Sons, wondered whether there was enough underwriting talent in Bermuda to accommodate all the new property catastrophe capacity. He noted that Phoenix Re had $125 million in capital, twelve underwriters, and $85 million of premiums.

How many underwriters will PartnerRe, with over $1 billion in capital, need? And where will these underwriters live? (According to Malis, executive level housing in Bermuda goes for about $12,000 a month, when you can find it .)

One thing is certain: PartnerRe can afford it.

Lutine Capital Corporation, which was formed in September, is named after the ill-fated British navy frigate that sank in 1799 with a hold full of bullion. (The Lutine's bell was later recovered and is now ensconced at Lloyd's, where it is rung to denote important events.)

Lutine Capital, which should rake in over $300 million from the investing public, will become a limited-liability corporate member at Lloyd's. For an investor eager to participate in Lloyd's but unwilling to accept unlimited liability, this might be the ideal vehicle. It is, at least for the time being, the only publicly held vehicle.

Lutine's prospectus mentions a host of reasons why now may be the time to invest: Lloyd's "is one of the leading insurance franchises in the world"; after years of horrible results things are starting to turn around; since 1948, Lloyd's has been profitable every year except 1964 to 1966 and 1988 to 1991; and even in 1990, Lloyd's worst year, 115 of 388 syndicates reported a profit.

In many respects, Lutine actually bears more resemblance to a closed-end mutual fund than it does to a traditional insurance company. It will not underwrite risks, collect premiums, or pay claims. Instead, it will operate in much the same manner as an individual Name might—it will allocate its capital to a variety of syndicates representing a diversified book of business.

Since Lutine did not have the expertise to select and monitor syndicates, it acquired Anton Members Agency Ltd., a firm specializing in this sort of work. With Anton's assistance, Lutine has reached agreements to allocate $318 million of capacity to forty-nine syndicates.

Several pages of Lutine's prospectus are devoted to the criteria it uses to select syndicates, and more than fifty pages are devoted to the actual results experienced by the chosen syndicates. These pages paint a rosy image. Whereas Lloyd's average annual loss from 1986 to 1990 was 3.8%, the syndicates chosen by Lutine averaged an 11.5% profit. Whereas Lloyd's lost £2,481 million during that period, these syndicates made an £896 million profit.

The figures are so impressive, so exciting, that one can almost taste the

BERMUDA

WITH ITS PINK SANDY BEACHES, balmy breezes and subtropical climate, Bermuda is *the* place to transact insurance business—especially if you're in the market for a tax haven with terrific golf courses. (Bermuda has the highest density of golf courses per square mile in the world.)

There are no local taxes on either income or premiums, and businessmen walk around in shorts, knee socks, jackets and ties. The stable parliamentary democracy, legal system based on British common law, and world class resort hotels make this an ideal spot for those who want to fish, swim and sail but say that they were working hard.

It's no wonder that Bermuda is headquarters to forty percent of the world's captive insurance companies—more than three times its nearest rival.

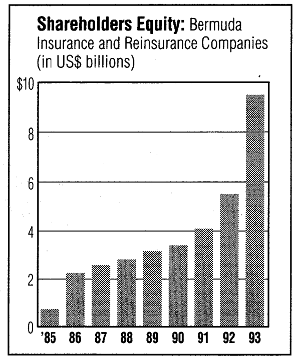
Insurance Facts

No. of insurance companies	1,324
Capital and surplus	$20 billion
Gross premiums	$15.4 billion
Assets	$52.5 billion
% of workforce in insurance	70%

Economic summary: Bermuda is a self-governing United Kingdom dependency. It has virtually no unemployment, a high standard of living, and over half a million tourists each year.

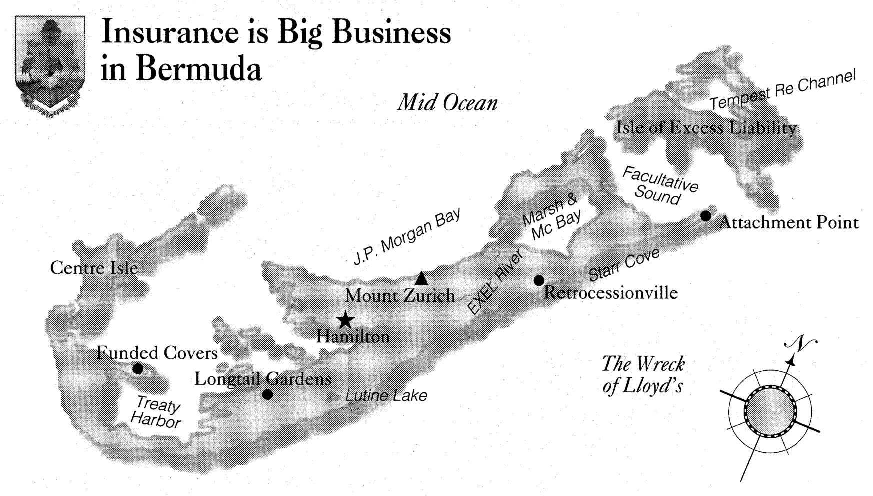
Captive Insurance Companies

Bermuda	1,240	Singapore	48
Cayman	372	Colorado	32
Guernsey	228	Bahamas	32
Vermont	225	Hawaii	28
Barbados	185	Tennessee	17
Luxembourg	160	Other non-U.S.	236
Isle of Man	125	Other U.S.	207
Ireland	65	TOTAL	3,200



General Information

Population	58,283
Area	21 sq. mi.
Arable land	0%
Natural resources	Limestone



Insurance is Big Business in Bermuda

profits. There's only one problem. They bear absolutely no relationship to the *actual* results experienced by Anton Members Agency in the past. Anton's real results, which are detailed in an eighth-of-a-page chart printed in very small type, are not especially good. The cumulative losses over the five-year period were £34 million.

In essence, the splendid historical results demonstrated by Anton in the *newly chosen* syndicates are the result of hindsight. We, too, could pick a list of Lloyd's syndicates that showed good results, just as we could pick a list of stocks that have gone up a lot over the last five years. Whether Anton's and Lutine's syndicate picking will turn in good results on a *prospective* basis remains to be seen.

There are other factors affecting Lloyd's that an investor in Lutine may want to ponder. The most important is whether Lloyd's will remain a viable market in the future. A fellow we know who runs a major insurance brokerage and is intimately familiar with Lloyd's offered up his thoughts under the condition that we not mention his name.

Reliance Group recently issued $200 million of stock and $650 million of bonds. Not a cent of this will go into the insurance companies.

"Lloyd's is a universal tragedy," he said. "It became the dumping ground of the world. Bermuda will cherry pick them to death."

David Rowland, the new chairman of Lloyd's, couldn't disagree more. He admits that Bermuda will provide competition, but downplays it. "There are some very good people in Bermuda," he says, "but some real turkeys, as well."

As for the new capital coming into Lloyd's, Mr. Rowland seemed more concerned that "too much" would come in, rather than too little.

We should all have such problems.

Hurricane Watch

Since the insurance industry is concerned about a big wind blowing the entire east coast of the United States all the way to Bermuda, we asked Ed Rappaport, a hurricane specialist at the National Hurricane Center, whether it was likely that hurricanes would hit land more frequently in the future.

"We don't make projections," he said, "and I haven't seen anyone who can do it accurately." He noted, however, that it's "just a matter of time, just a matter of statistics," before a major hurricane hits a major city.

The National Hurricane Center can envision a storm far worse than Hurricane Andrew's $17 billion in losses. It would hit Dade County, causing perhaps $45-50 billion of insured damage, then move north through Fort Myers, across the Gulf of Mexico and on to New Orleans.

Although this sort of thing might happen every few hundred years, it's just the sort of thing that now worries underwriters.

Debt be not proud

The Insurance Federation of New York is as venerable an institution as it can be considering that they've let the likes of us in, and they are engaged in a variety of nice activities, one of which is their annual Free Enterprise Award luncheon at the Waldorf.

The givers of this award have chosen many worthwhile and deserving recipients over the years, but they are not infallible. Several years ago the award was bestowed upon Donald Trump, the famous real estate deadbeat. Another poor recent choice was J. Peter Grace, the over-opinionated geriatric who, throughout his seemingly endless business career demonstrated time and again how to make a fortune in industry: start with a fortune.

Although we're not privy to the reasons why Saul Steinberg, the chief honcho at Reliance Group, was this year's recipient, we admit that this canny leverage-meister is an absolute master of the free enterprise system. Anyone who can run a big company (as he does) whose stock and book value have declined over the last seven years (as his have), yet still manage to get paid $6,000,000 a year (as he does), certainly deserves some sort of award. Indeed, based upon Reliance Group's recent offering of $200 million of stock and $650 million of debt, we think Mr. Steinberg may be the first person to win the Free Enterprise Award two years in a row.

Reliance's sale of stock and debt is the cornerstone of the company's "Capital Enhancement Plan." Although this plan will reduce Reliance's annual interest expense by about $20 million a year, the company will still have close to $900 million of total debt against $500 million in shareholder's equity.

While one could focus on Reliance's underwriting losses, its concentration of lower-rated bonds, or its fairly heavy exposure to equities, we'll skip that

Gone, but Not Forgotten

THE TREND to self-insurance and alternative risk financing has had a profound effect on insurers and brokers. Just as the banks ultimately lost many of their best customers to the commercial paper market, insurance companies and brokers have lost many of their best units of risk to the alternative markets.

As the accompanying chart indicates, the total worldwide insurance and risk-financing market is about $350 billion, twenty-five percent of which is comprised of funded self-insurance or alternatives such as captives and financial insurance.

Worldwide Market for Insurance and Alternative Risk Financing ($ billions)

Conventional Insurance Market	$260.0
Worldwide Funded Self-insurance	
Workers Compensation	18.1
Other	46.9
	65.0
Other Alternative Risk Transfer	
Captives	14.0
Financial Insurance	4.5
Specialty Insurance	2.0
	22.0
Total Worldwide Market	$347.0

Source: *Tillinghast*

stuff. We've covered it before (*Emerson, Reid's*, March 1992) with surprising results. At that time we stated that Reliance Insurance Company's preferred stock was a dandy buy—despite the company's various problems. (Those who followed our lead have made about thirty-five percent on their money in eighteen months, in an extremely low-risk investment.)

This time around, we'll pass on all of Reliance's securities, for a variety of reasons. The common stock is not our cup of tea because we don't want to pay two times book value to be Mr. Steinberg's partner, and the debt is of no interest because, in general, buying junk bonds at par seems like a fool's game.

What does interest us, however, are some slight changes in the wording of Reliance Group's prospectus. At year end 1992, the company's 10K—in a shift from previous years' 10Ks—noted that Reliance's ability to maintain its A- Best rating "depends on a number of different factors, not reasonably within its control...."

That wording is now gone—it appears nowhere in the *Investment Considerations* section of the prospectus, but some other language remains: "A downgrade in the Best rating below A– could adversely affect the competitive position of the Reliance Property and Casualty Companies." A downgrade below B+ will do more than just hurt Reliance's competitive position, it would also put it in default of one of the covenants of its new $175 million credit facility.

Although Reliance "believes that the consummation of the Capital Enhancement Plan will improve its ability to receive ratings upgrades in the future," not one cent of the $821 million raised will go into the Reliance Insurance Company. Instead, it will be used to repay the debt of various Reliance holding companies.

While this, in an of itself, won't improve Reliance Insurance Company's financials, it does give the parent company, Reliance Group, a lot more breathing room. This new found flexibility could be used to expand the business, repay more debt, or, perhaps, give Saul Steinberg a raise.

After all, that's the free enterprise system. ■

Some Rob You With a Six-gun, Some With a Fountain Pen

New York State's Workers' Compensation Fund Is on the Brink of Insolvency

Although your average Joe thinks that politicians are liars, he has great faith that their handiwork—the government—will make good on the promises made by these same politicians. This lapse in logic is understandable. The federal government can print all the money it needs to pay its obligations, and local governments, despite some difficult times here and there, generally don't default on their obligations. Just because the worst rarely happens, that doesn't mean it can never happen. Although state governments have many powers, they have no power to repeal the basic laws of mathematics. Bills can be delayed, rolled over, or even ignored, but eventually they must be paid.

Which brings us to the New York State Workers' Compensation Fund, an ailing behemoth with over $6 billion in assets, 193,670 policyholders, 2,900 employees, and forty-eight percent of the New York workers' compensation market.

The Fund is no stranger to us; we've been following its sorry decline for years and feel confident saying that were it a publicly owned enterprise it would have been seized by the insurance department and its directors served with class-action lawsuits.

Since the Fund is a New York state agency, this hasn't happened. Instead, the pretense that it's healthy has been perpetuated even though analysis and common sense indicate otherwise. In fact, the situation has deteriorated to such an extent that from our perspective the Fund looks like a Ponzi scheme, promising payment when it hasn't an adequate margin of funds to do so.

Some of the Fund's problems stem from the fact that, because it had lots of assets *just sitting there*, it became a political piñata: it was knocked about and skewered and its assets were grabbed. Beginning in 1982, the New York State Legislature passed a series of laws requiring the transfer of $1.3 billion from the Fund to the state. (Such fiscal legerdemain had the miraculous effect of reducing New York State's deficit by a like amount.) These $1.3 billion of transfers are now carried on the Fund's balance sheet as a non-interest-bearing "contingent receivable."

The liability side of the Fund's balance sheet has also been jiggered to improve its appearance. Beginning in 1986, losses and loss adjustment expenses were discounted to present value using a 3½% interest rate. In 1989, a 5% discount rate was employed. By year end 1992, these pen strokes had reduced the Fund's liabilities—and therefore, increased its surplus—by $1.93 billion. Had these changes not been effected, the Fund would now have a *negative surplus* (a fitting term for a government agency) of $1.85 billion.

While this new accounting treatment may present a more accurate picture of the Fund's long-tailed liabilities, it is an inherently less conservative picture. Furthermore, the accounting changes haven't stopped the flow of red ink. For the years ending 1989, 1990, 1991 and 1992, the Fund lost $146 million, $39 million, $95 million, and $495 million, respectively, and total surplus declined from $829 million to a paltry $77 million (*including* the $1.3 billion contingent receivable).

This raises troubling questions: can a mere sliver of surplus support an insurance company with $1.4 billion in premiums and $6.1 billion in assets? Can the Fund ever make money? And, finally, can the Fund become insolvent?

Although the first two questions are rhetorical, the third is not, and the answer will undoubtedly upset some: the State Insurance Fund can become insolvent, and in fact may already be so.

It's an ugly thing to call a venerable institution insolvent, and it's not something one should do lightly, or in the heat of partisan politics. Policyholders' fear of insolvency can hasten the decline of a weak insurer and bring an otherwise strong company to its knees. On the other hand, it's equally irresponsible to see reckless behavior and not call attention to it.

Despite the Fund's weakened condition, its 1992 annual report uses the same cheerful tone as did earlier annual reports: the Governor "commends" the board of commissioners and the Chairman calls the Fund's growth "impressive." But neither the Governor's Message nor the Chairman's Message makes mention of the half-billion-dollar 1992 loss or the drastic decline in surplus.

Executive Director Cecilia Norat's message also bears similarity to her previous messages, except in one respect—in the past she thanked the Fund's employees for their "daily commitment" which contributed to its "success." This year she says the employees' "daily commitment" contributed to "our maintaining a viable and solvent State Fund." There is no mention of "success."

How can a $495 million loss contribute to "maintaining a viable and solvent" State Fund? And why did Ms. Norat chose to mention "viable and solvent" at a time when the Fund's financials have never looked dicier?

Perhaps the most notable addition to the 1992 annual report, however, is a sentence in the back, in the section entitled Notes to Statutory Financial Statements. It reads: "As an agency of the State of New York, all liabilities of the Fund are guaranteed by the State, *should the Fund become insolvent.*" [Emphasis added.]

That language—the first of its kind—implies that it's possible for the Fund to go bust, and it raises a good question: How do you know when an insurance company is insolvent?

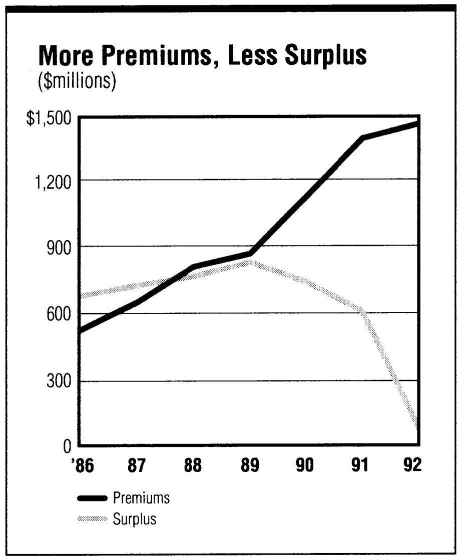
There is no simple answer. In the past, the Fund's supporters have argued that it is in fine shape—that it generates positive cash flow and can easily pay claims. That's true...in the short run. Since workers' compensation liabilities are extremely long-tailed, the Fund—or any insurer for that matter—could pay claims for a while. In fact, even if the Fund gave away coverage for the next few years, it would be able to meet all claims during that period. Because the Fund's liabilities go out as far a sixty years into the future, there are serious doubts as to whether it will be able to meet these liabilities. Because this is a long-term, rather than a short-term problem, it's of less concern to politicians. After all, they'll probably be dead or out of office when the claims have to be paid.

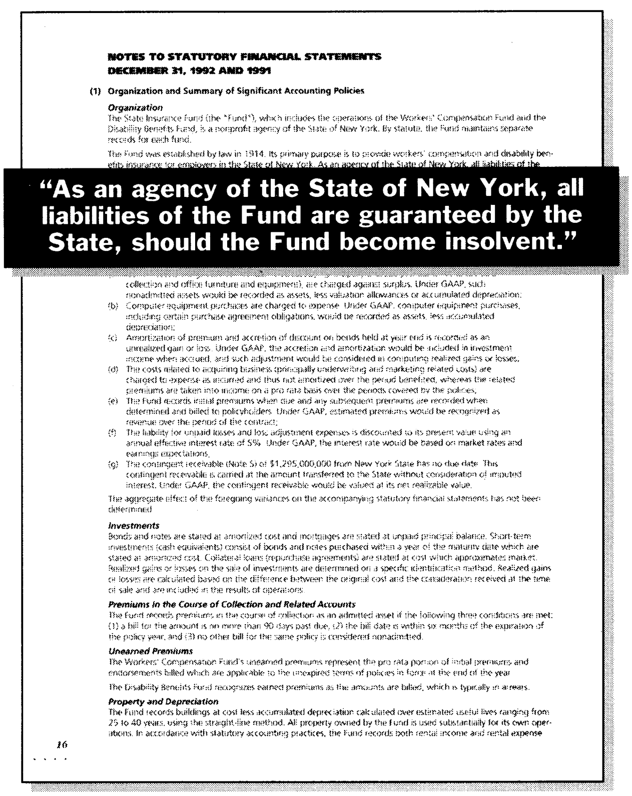
Disasterville: The New York State Workers' Compensation Insurance Fund

	1992	1987
Policyholders	193,670	190,918
Employees	2,900	2,500
Surplus	$77,252,000	$724,740,000

So when is an insurance company insolvent? We prefer the old-fashioned definition: when its liabilities exceed its assets. Since that old fogeyish attitude isn't shared by the folks who run the Fund, we'll pose a different question: How deep in the hole can the Fund go before it becomes insolvent? $1 billion? $3 billion? $5 billion? Or is there no figure so large that the Fund can't, somehow, work it out?

Even if New York were to repay the $1.3 billion it took—and it won't be easy for the state to do this—it wouldn't come close to assuring solvency.




NOTES TO STATUTORY FINANCIAL STATEMENTS
DECEMBER 31, 1992 AND 1991

(1) **Organization and Summary of Significant Accounting Policies**

Organization
The State Insurance Fund (the "Fund"), which includes the operations of the Workers' Compensation Fund and the Disability Benefits Fund, is a nonprofit agency of the State of New York. By statute, the Fund maintains separate records for each fund.

The Fund was established by law in 1914. Its primary purpose is to provide workers' compensation and disability benefits insurance for employers in the State of New York. As an agency of the State of New York, all liabilities of the

"As an agency of the State of New York, all liabilities of the Fund are guaranteed by the State, should the Fund become insolvent."

collection and office furniture and equipment), are charged against surplus. Under GAAP, such nonadmitted assets would be recorded as assets, less valuation allowances or accumulated depreciation;

(b) Computer equipment purchases are charged to expense. Under GAAP, computer equipment purchases, including certain purchase agreement obligations, would be recorded as assets, less accumulated depreciation;

(c) Amortization of premium and accretion of discount on bonds held at year end is recorded as an unrealized gain or loss. Under GAAP, the accretion and amortization would be included in investment income when accrued, and such adjustment would be considered in computing realized gains or losses;

(d) The costs related to acquiring business (principally underwriting and marketing related costs) are charged to expense as incurred and thus not amortized over the period benefited, whereas the related premiums are taken into income on a pro rata basis over the periods covered by the policies;

(e) The Fund records initial premiums when due and any subsequent premiums are recorded when determined and billed to policyholders. Under GAAP, estimated premiums would be recognized as revenue over the period of the contract;

(f) The liability for unpaid losses and loss adjustment expenses is discounted to its present value using an annual effective interest rate of 5%. Under GAAP, the interest rate would be based on market rates and earnings expectations;

(g) The contingent receivable (Note 5) of $1,295,000,000 from New York State has no due date. This contingent receivable is carried at the amount transferred to the State without consideration of imputed interest. Under GAAP, the contingent receivable would be valued at its net realizable value.

The aggregate effect of the foregoing variances on the accompanying statutory financial statements has not been determined.

Investments
Bonds and notes are stated at amortized cost and mortgages are stated at unpaid principal balance. Short-term investments (cash equivalents) consist of bonds and notes purchased within a year of the maturity date which are stated at amortized cost. Collateral loans (repurchase agreements) are stated at cost which approximates market. Realized gains or losses on the sale of investments are determined on a specific identification method. Realized gains or losses are calculated based on the difference between the original cost and the consideration received at the time of sale and are included in the results of operations.

Premiums in the Course of Collection and Related Accounts
The Fund records premiums in the course of collection as an admitted asset if the following three conditions are met: (1) a bill for the amount is on more than 90 days past due, (2) the bill date is within six months of the expiration of the policy year, and (3) no other bill for the same policy is considered nonadmitted.

Unearned Premiums
The Workers' Compensation Fund's unearned premiums represent the pro rata portion of initial premiums and endorsements billed which are applicable to the unexpired terms of policies in force at the end of the year.

The Disability Benefits Fund recognizes earned premiums as the amounts are billed, which is typically in arrears.

Property and Depreciation
The Fund records buildings at cost less accumulated depreciation calculated over estimated useful lives ranging from 25 to 40 years, using the straight-line method. All property owned by the Fund is used substantially for its own operations. In accordance with statutory accounting practices, the Fund records both rental income and rental expense

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A new disclosure

Ultimately, that can only be done by profits; and profits, if you are the Fund, or one of many other carriers writing workers' compensation, aren't easy to come by.

Since the Fund attracts business by having low rates, raising rates is not necessarily a solution, either. Higher premiums could drive away business.

So who's to blame for the Fund's predicament? Is it the Fund's executives, for not calling more attention to the problems? Is it the legislators, for increasing benefits and stripping the Fund's assets? Or is it the voters, who chose legislators who told them what they wanted to hear, even if it wasn't true?

We'll blame the legislators. Too often, they just don't seem to understand insurance. Although workers' compensation has been, at best, a marginal line for most insurance companies, Sheldon Silver, chairman of the Assembly Ways and Means committee, recently defended the Fund by blaming others: "If private insurers limited their profits on workers' compensation, premiums could be reduced across the board."

Run that by us again. ■

Swaps and Derivatives

AIG Moves into Hyperspace

Although his name appeared nowhere in AIG's annual report, Howard Sosin, a former professor who once worked at Bell Laboratories, may well have been the giant international insurance organization's highest-paid employee. According to *The Wall Street Journal,* his 1992 compensation was in the neighborhood of $40 million to $50 million.

Until recently, Sosin ran AIG Financial Products, a major player in the "swaps" and "derivatives" market. Swaps and derivatives are financial transactions where returns are tied to variables such as interest-rate, currency, stock, or commodity prices. For example, a fixed interest rate might be swapped for a floating interest rate, or a deutsche mark liability swapped for a yen liability.

According to those in the know, AIG and Sosin were willing to venture into the ionosphere of international high finance considered too risky by others: arranging swaps going out thirty years into the future. In 1992, AIG Financial Products' profit of $171.5 million represented eight percent of AIG's pretax profit.

AIG's non-insurance operations have been growing rapidly, and the Financial Services Group—which includes AIG Financial Products, International Lease Finance (which leases and markets jets), AIG Trading, and subsidiaries engaged in Swiss-based private banking, premium finance, asset management, merchant banking, and stock brokerage services—now accounts for 15.5% of AIG's pretax profit.

What interests us most about AIG Financial Products is not Mr. Sosin's eventual falling out with AIG, or even the vast amount of money involved, but the reminder that the insurance business has become the money business, and the reminder that the rewards—and the risks—of the money game are vastly different from those of the traditional insurance game. (To be technical about things, AIG Financial Products is a subsidiary of American International Group, Inc., the holding company that owns the insurance companies.)

AIG's Financial Services division has assets and liabilities of $23.5 billion and $21.2 billion, respectively—about thirty percent of American International Group's total—and at year end 1992 was "short" $1.5 billion of spot commodities.

AIG Financial Products has entered into interest rate and currency swaps and currency forward commitments with a notational principal amount of $82.4 billion. "Assuming nonperformance by the counterparties on all contracts," says AIG's annual report, "the maximum potential loss...at December 31, 1992 approximated $4.3 billion," up from $2.8 billion the previous year. This "maximum potential loss" will increase in size over the life of the swaps. Although AIG attempts to hedge its risks, there's no such thing as the perfect hedge. Still, nonperformance by all parties—which is what could cause the maximum loss—seems farfetched.

As large as these figures are in absolute terms, they must be viewed in light of American International Group's $12.8 billion of capital funds.

AIG's stock was recently trading at $88, about sixteen times earnings—a higher than average multiple. Obviously, an investor must consider AIG's top financial ratings, its strong international presence (fifty-two percent of earnings come from outside the United States) and the possibility of an improvement in insurance pricing. Considering that AIG's recent earnings growth has been fueled by its Financial Services and Life Insurance operations, and considering that financial services giants such as J. P. Morgan and Salomon trade at considerably lower multiples than does AIG (because of the perceived uncertainty of their earnings streams), one might attribute AIG's higher-than-average stock-market multiple to its insurance operations, whose earnings have been flat. In other words, in the stock market, the whole of AIG seems to be worth more than the sum of the parts.

That sounds a bit odd, at least to us. On the other hand, maybe it's worth it. ■

AIG: Big Growth in Financial Services

AIG's Pretax Profit by division ($ millions)

	General Insurance	Life Insurance	Financial Services
1987	818	319	39
1988	944	387	87
1989	1,099	453	143
1990	1,286	462	100
1991	1,263	561	216
1992	1,124	667	332
1993 – 9 Mo.	$ 995	525	285

Price, Service, Loyalty, and the Independent Agent

During a town meeting at the annual Independent Insurance Agents of America convention, a question was posed to the audience: does customer service make a difference?

That eighty-one percent of the agents answered "yes" is not surprising. That nineteen percent actually said "no" is.

Most (seventy-nine percent) agreed that "cost" is more important than "service." That was troubling because, as the agents see it, they're in the business of providing "service." Indeed, in a recent survey most agents claimed to provide better service than their competitors. But ask any insured what he thinks and he'll probably say that getting a low price is an important part of an agent's service.

The agents at the conference had a hard time coming to grips with this and looked for someone to blame. The most popular scapegoats were insurance companies and the government, although a tally of the agents revealed that eighty percent felt that their customers were "less loyal."

Been Down So Long It Looks Like Up

By David Schiff

David Schiff attends the annual NACSA/NACSE junket and bites the hand that feeds him.

Since it's important for *Emerson, Reid's Insurance Observer* to stay plugged into all sorts of industry scuttlebutt—especially if that scuttlebutt is in a luxurious place with a pleasant climate—I decided to go to the sixty-fourth annual NACSA/NACSE (National Association of Casualty and Surety Agents/National Association of Casualty and Surety Executives) conference held at the famed Greenbrier Resort in White Sulphur Springs, West Virginia, last October. As a member of the press, I generally attend this sort of thing without having to pay the conference fee.

Attending wasn't so easy, however, because NACSA told me that my "press credentials" weren't in order.

The Greenbrier

"Press credentials?" I said to the man in charge. "What sort of press credentials do I need?"

That turned out to be a difficult question. "Well," he answered after a while, "is your newsletter recognized by the White.House?"

Although Bill Clinton isn't a subscriber (yet), I responded with a lie. "I'm not sure."

That didn't satisfy him. "Are you accredited by any agencies?"

"Who knows, but thousands of top insurance executives read us. I've also written for many magazines—*Barron's*, for example—and I'm a contributing editor of *Worth*, and I've never been asked about 'agencies' before. By the way, what sort of 'agencies' are you referring to?"

"You don't meet our criteria," he averred.

"But what are your criteria?"

"You have to be a recognized industry publication."

I insisted we were, while he explained that the "criteria" were not those he could easily explain, although he was dead certain we didn't qualify.

The man from NACSA has always recognized the *Insurance Advocate*, for which I'm an occasional columnist, and would only allow me to attend in that capacity—a blow to my pride, and a move on his part that didn't make me predisposed to write favorably of him or his organization, which is, after all, why they let the press in for free in the first place.

For those of you unfamiliar with the NACSA/NACSE meeting, suffice it to say that it's a fancy shindig that draws about 350 of the largest insurance brokers, 250 senior executives of insurance companies, and their spouses.

The formal working agenda is limited. Oh sure, there are a few morning seminars attended by a bunch of people who couldn't get a tee time, but the real action takes place at black-tie cocktail parties and dinners hosted by the insurance companies, and on any one of the three championship golf courses.

Although I didn't go near a golf course, I managed to keep busy. One morning I dragged myself to a seven o'clock breakfast meeting where twenty gloomy American Names at Lloyd's compared notes, griped, and looked for a way to avoid paying their liabilities. Although this sophisticated group included top brokers, the owner of a prosperous insurance company, and the president of one of the largest insurance companies, many of them seemed to think there was nothing wrong with attempting to renege on their unlimited liability, which, in theory, could be down to their last cufflink.

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$75 Billion

Federal Disaster Reinsurance Fund

Contingent U.S. Treasury Liabilities

It is hoped that this program will be financed by the insurance industry. However, in the event of a shortfall in funds after a disaster, money may be borrowed from the U.S. Treasury. Although it is intended that the insurance industry will repay these loans, there can be no assurance that the funds will actually be repaid, nor can there be any assurance that the losses won't exceed $75 billion.

Alliance of American Insurers **American Insurance Association**

Independent Insurance Agents of America **National Assoc. of Independent Insurers**

National Assoc. of Mutual Insurance Companies **Professional Insurance Agents**

Reinsurance Association of America

Some of the Names alleged fraud or conspiracy; others were not so sure. Most agreed, however, that they were fools for having got involved with Lloyd's. "I wanted to be part of the club," said one sad Name.

"It sounded so easy, and I was greedy," another remarked.

"It's incredible we fell for it," said one Name who was actually increasing his writings. "They were doing business like it was the nineteenth century: everything was on slips of paper. They weren't even using computers."

So how was it that this shrewd bunch of top insurance executives—who should have known better—managed to lose their shirts at Lloyd's?

They were suckers for a British accent, a pin-striped Savile Row suit, and three hundred years of tradition.

On Monday evening I dropped in at the Travelers' cocktail party and said hi to Sandy Weill, the chairman of Primerica (which will soon take over Travelers). Since Weill stood at the entrance and said hello to everyone who entered—demonstrating beyond a doubt that he was already firmly in charge—I didn't really have a chance to engage him in conversation.

I did ask the president of one of America's largest and most successful brokers what he thought of Primerica's takeover of the Travelers. After insisting on anonymity, he lambasted insurance companies, calling them "large and hidebound," and said that Weill is "a breath of fresh air."

Although Weill is famous for cutting costs to the bone, one wouldn't have known it from sampling the food at the Travelers' reception.

Those at the Greenbrier slept in five-hundred-dollar-a-day suites and paid plenty extra to play golf.

Although the insurance cycle is such that one would expect insurance company executives to be a rather unhappy lot, the opposite appeared to be true at the Greenbrier. Despite the vagaries of this prolonged down cycle, underwriters have had the consolation of seeing their companies' stocks rise dramatically over the past couple of years. Furthermore, many of the companies in attendance have recently raised capital on Wall Street, or are planning to. The president of one smaller insurance company, which raked in tens of millions of dollars recently by issuing new shares, told us he really had no use for the extra cash right now but that he'd put it to work sometime in the future. Left unsaid was the fact that his company's sky-high stock price made it a wonderful time to sell equity.

Indeed, the amount of money being thrown at the insurance business is shocking, and there seems to be unanimity on Wall Street that the insurance business is a great investment. Such bouts of financial euphoria often end badly for the investors, but as the old saying goes, "If they weren't meant to be sheared, God wouldn't have made them sheep."

As I wandered through the Greenbrier's stately halls and grand, high-ceilinged dining room, mingling with the cream of the insurance crop, I didn't pick up a sense of fear among underwriters, or a sense that disaster might be imminent, or perhaps already there. Everybody admits "the industry" is underreserved, but says it's some other insurance company, not theirs.

Despite the inevitable bafflegab about "increasing productivity" and "downsizing," those at the Greenbrier slept in five-hundred-dollar-a-day suites, attended lavish receptions, and paid plenty extra to play golf and use the spa facilities. Many arrived in private jets.

Perhaps this really is the beginning of a great profit cycle in the insurance business. I'm skeptical, however. As something of a contrarian, I generally believe that the time to buy is when blood is flowing in the streets.

At the Greenbrier, the only thing flowing was champagne.

I certainly look forward to returning next year. ■

James Grant, 'Observer' Extraordinaire

The World's Greatest Financial Writer Has a New Book Out.

We first came across Jim Grant during the giddy boom years of the 1980s. Although we no longer recall how we originally got a copy of his fortnightly journal with the unappealing moniker of *Grant's Interest Rate Observer*, it was clearly fortuitous, because the subject of interest rates had as much allure to us as did the winning recipe for the Pillsbury bake-off.

Despite its name, *Grant's Interest Rate Observer* is not about interest rates. It is, in the broadest sense, about financial markets, which to Jim Grant comprise not just stocks and bonds, but scrap metal, currencies, real estate, mortgages, airplanes, credit-card receivables, insurance companies, bank loans, gold, copper, and cash.

It took just a couple minutes of reading for us to fall in love with *Grant's Interest Rate Observer* and begin dreaming of a *lifetime* subscription. (One-year subscriptions are available for $470, a real value.) We realized immediately that Grant was that rare voice—a brilliant, iconoclastic journalist and historian who writes with startling elegance, wit, and insight. His words are all the more impressive, however, because they're produced in great volume and under severe deadline pressure. Although one would expect such work to be of only fleeting interest and value—that once the moment has passed it would be as dull as last year's box scores—that's not the case, as Grant's latest book, *Minding Mr. Market: Ten Years on Wall Street with Grant's Interest Rate Observer* (Farrar Straus Giroux, $27.50), proves.

Grant probably didn't write his chronicles with the idea that they'd serve as first-rate financial history, but they do. His perspective—although not infallible, as he would be the first to point out—is always entertaining, and his cleverness makes the driest subjects not just understandable, but fascinating. For example, he describes Alan Greenspan, the Chairman of the Federal Reserve, as "another guy with a business suit and a personal computer who thinks he can make an honest woman out of paper money," and explains that "misconceived real estate lending is an American staple. Overbuilding brought on by overlending is a recurring phenomenon, and the first bad real estate loan no doubt occurred along about the opening of its first bank.... I do not mean to sound a note of pure fatalism, but the truth is that people with money, acting in crowds, periodically go off the deep end."

Minding Mr. Market touches on everything from the "McMortgage—the fifteen-minute mortgage decision," to the Charles Keating's infamous Lincoln Savings & Loan. (In 1988, Grant called its parent company's debentures "the worst securities available.") There are tales of Drexel Burnham, the Reichman's ill-fated Olympia & York, Donald Trump ("Sell Donald Trump" written in 1988), the Eurotunnel and more.

Grant was one of the earliest—and certainly the most eloquent—critic of the new-age finance of the past decade. In September 1984, in an issue entitled "Special Fall Junk Edition—Junk Debunked," he stated his position: "*Grant's* is anti-junk. While conceding the extraordinary record of high-yield bonds, we would observe, to start with, that the present-day world is very long on debt and very short on equity.... According to an old investment adage, one should own the thing in short supply and shun the thing in surplus. . ."

Back in 1985, Grant opined that the 1980s were "the true Jazz Age of finance," but said, "the idea that the 1980s are a simple replay of the 1920s has never sat too well around here. It is too pat and too popular. If the past were really so obliging as to repeat itself literally, the historians would have all the money."

Although Grant is often a champion of orthodoxy in financial markets, he's not a stopped clock that's right twice a day. He is ever on the lookout for change in the markets, which, he believes, occurs at the margin. His skeptical nature often makes him early, but not wrong.

Jim Grant became a hero to us, not because he had discovered some financial alchemist's stone, but because of the eloquence of his words, the force of his intellect, and perhaps equally important (and especially rare on Wall Street), his humility. It was for all these reasons that when we first met some years ago, we approached him with the trepidation of a little leaguer asking Mickey Mantle for an autograph. He was, of course, gracious, and we've since struck up a friendship. In fact, readers of *Grant's Interest Rate Observer* may notice that *Emerson, Reid's Insurance Observer* bears a passing resemblance to *Grant's*. We were pleased that Jim viewed this as an homage. Nothing, however, delighted us more than the inscription he wrote in our copy of his last book, *Money of the Mind*. It said, "To a friend and crusader."

Thanks, Jim. ■

Jim Grant, down from the mountain top, lays down the law.

The Insurance Beat

Policy #38DD

FRONTIER INSURANCE COMPANY, the successful specialty insurer that brought us bungee-jumping coverage several years ago, is coming out with another innovation: breast implant warranty coverage. Under the terms of the new all risks policy, coverage is provided for damage to saline breast implants. Since breast implants run about $1,000, and since the cost of the coverage will be $79 for an eight-year policy, it seems that this important new risk management tool should fill a void that has existed in the market.

We asked Walter Rhulen, Frontier's president, whether he had any plans to extend this policy to include business interruption coverage for topless dancers who have augmented their figures, and fortunes, with breast implants.

"Interesting idea," he said with a smile.

The Weak Insuring the Weak?

RELIANCE NATIONAL, which is part of Reliance Insurance Group, has begun offering Excess Depositors' Liability Insurance. In the event a bank is declared insolvent and is unable to repay its deposits, this coverage will kick in after the $100,000 FDIC insurance limit.

Since Reliance is only rated A– by Best's and BBB+ by Standard & Poor's, it seems like an unlikely company to provide this sort of financial guaranty. After all, wouldn't one who worries about banks failing prefer to buy coverage from an insurance company with unquestioned financial strength?

'Archaic, Inefficient, and Mediocre'

"THE INSURANCE industry is in a dreadful state," declared Ronald Forrest, the former Chairman and CEO of Alexander & Alexander's U.S. brokerage operations, to a bunch of folks who had nothing better to do than attend the annual meeting of the Society of Chartered Property and Casualty Underwriters. "It's archaic, inefficient, and its infrastructure smacks of mediocrity."

Mr. Forrest's comments, which were right on the money, come at a moment of truth for Alexander & Alexander. Its financial results have been perennially disappointing and its operations seem to be in a perpetual state of restructuring. As a result, the "wait till next year" pronouncements are now doubted by all, especially those unfortunate enough to be long-term shareholders. (A&A's shares recently traded at $17¾, about twenty-five percent lower than their 1972 price.)

On November 8, *Business Insurance* and *National Underwriter* mentioned that A&A might be ripe for a takeover. The mathematics of such a deal are compelling—at least on paper. For starters, A&A's $31 million corporate overhead could be cut, perhaps to zero, and a new owner with overlapping offices and a fresh perspective could probably lop off another $25 million or so without much effort.

Management has stated its desire for the company to remain independent, and hostile takeovers of insurance brokers are just about unheard of. Nonetheless, a would-be buyer could make an offer, and A&A would have few viable options.

What would it take to acquire Alexander & Alexander? Not all that much. Aon Corp., for example, could probably accomplish a merger at only a slight premium to the current price. In other words, A&A's $1.3 billion in revenues could probably be had for less than a billion dollars of stock.

That doesn't sound too expensive, but then, A&A's earnings have been going downhill since 1980.

The Consumer Be Damned

REGARDING a District of Columbia Court of Appeals decision reaffirming the right of national banks to sell insurance in small towns, Senator Jim Sasser of Tennessee said the following: "As national banks drive through this loophole, they are driving out of business many independent agents who cannot compete against them."

He didn't say why it was desirable to keep these uncompetitive agents in business.

Tell 'Em What They Want to Hear

THE 1,600 INSURANCE executives who recently converged on Toronto for the forty-eighth annual meeting of the National Association of Independent Insurers heard a variety of featured speakers lambaste the federal government for its attempted intervention in the insurance business.

Lawrence Kudlow, the chief economist at Bear, Stearns, told the audience that "security is the Nineties' buzzword for socialism." Dan Quayle, who last we heard was looking for life insurance acquisitions for his recently formed Circle Investors, hit home on that theme: "President Clinton has failed to notice that socialism doesn't work."

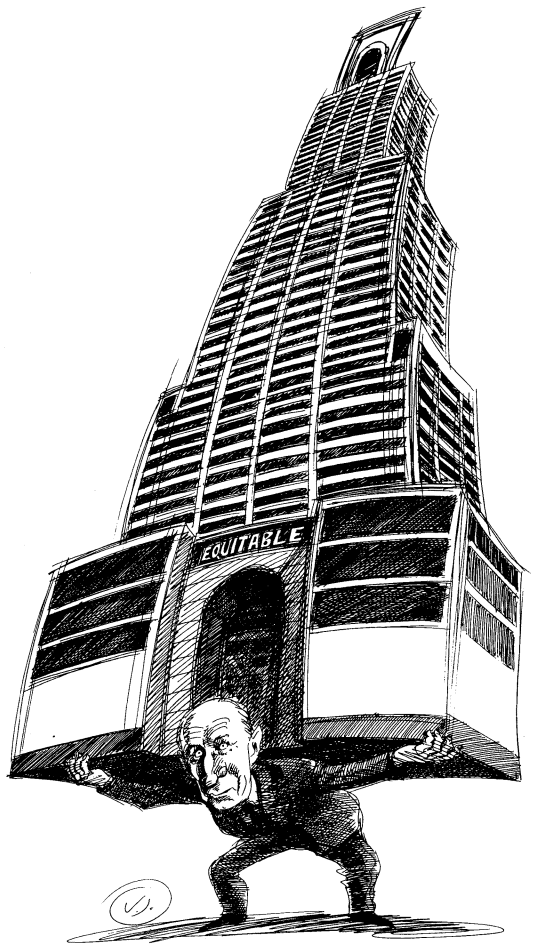
The former vice president, who, during his tenure in office was often ridiculed for spouting hopelessly garbled misinformation, criticized Clinton for hiring David Gergen, that "master of creating perception." Said Quayle, "The president is trying to govern by information."

Jim Bunning, the Kentucky congressman who struck out 2,855 batters during his Major League career, labeled Clinton's health plan "socialized medicine" and said "the best thing we could do for our fragile economy is send Congress home and keep it there for a long time."

Stephen Foster, Virginia's commissioner of insurance and president of the NAIC, defended state insurance regulation, calling dual federal/state regulation "the worst of all possible worlds—a recipe for disaster."

Despite the speakers' libertarian, laissez-faire, anti-federal-government approach, none, to the best of our knowledge, criticized the insurance industry's anti-competitive attempts at keeping banks out of the business, or found fault with the proposed federal natural disaster legislation supported by the insurance industry.

Maybe next year. ■



Richard Jenrette, chairman of The Equitable Companies

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