EMERSON, REID'S

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Deceit Is Alive and Well

Sold, not bought

Philosophical question: Is it okay to pad an insurance claim to make up for all the insurance premiums you've paid over the years, or to make up the deductible?

Forty-six percent of the people in large cities think it is, according to a recent survey, and twenty percent say there's nothing wrong with making false statements on an insurance application. Another study showed that forty-six percent of the employers in Florida lied about their payrolls to reduce workers' compensation premiums.

About the only thing one can conclude from this is that people, by and large, have a sleazy streak in them. And this sleazy streak is not confined to the general public, it includes folks in that most noble of professions—the insurance business.

For example, forty-three of New York's 400 public adjusters pleaded guilty to cheating insurers out of $43 million by creating bogus claims and then bribing insurance company employees to pay these claims.

"Annuities! Annuities! Get your high-yield, tax-sheltered annuities!"

Or take the case of Norman Bramson, who, with his sons Leonard and Martin, created a network of forty-three unlicensed insurance companies that bilked physicians by providing nonexistent medical malpractice coverage and diverting the premiums to bank accounts in Canada, the Caribbean, Germany, Denmark, and Luxembourg.

Sleaze is not confined to the marginal players in the business. MetLife agents in the company's Tampa office, remembering the old adage that "life insurance is sold, not bought," peddled something called a Nurses' Guaranteed Retirement Savings Plan which offered "high money-market interest rates." The only thing they forgot to make clear was that this was actually a whole life policy, not an investment plan.

In the old days, a life insurance salesman didn't have to resort to this sort of deceptive practice. Instead, he used a time-honored sales pitch: he stressed that you might die. Now, as the boundaries between life insurance and other financial services have diminished, that isn't enough. Competitive pressures have forced salesmen to sell yield. Lest you have any doubts that the life insurance business is really the investment business, it's worth noting that 1986 was the year that annuity premiums first exceeded life insurance premiums, and that right

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now seventy percent of the life insurance industry's reserves are the result of annuities. In other words, people are more concerned with financing their retirement than with financing their death.

Therefore, it seems only natural that banks would like to get into the action. Not surprisingly, the National Association of Life Underwriters, an agents' association, isn't pleased. "Keeping banks out of the insurance business has been a long-standing issue," says the NALU.

When a recent survey conducted by the old codgers at the American Association of Retired Persons showed that eighty-six percent of bank customers didn't understand that annuities sold at banks are *not* guaranteed by the FDIC, the NALU, predictably, expressed "grave concern." (The annuities are issued by life insurance companies.)

Robert Tedoldi, the NALU's president, said he was particularly concerned that banks have aggressively marketed uninsured investment products to older Americans. He also faulted banks for selling expensive credit life insurance and charging "outrageously high interest rates" on their credit cards.

"Banks say they want to enter insurance and other non-banking businesses because they can offer these products at more competitive rates," Tedoldi said, but "this certainly has not been the case with the few insurance products they have been allowed to sell to date." He didn't mention Savings Bank Life Insurance, which is quite a good deal for consumers.

If a recent Towers Perrin survey of life insurance company CEOs means anything, it appears that the NALU is somewhat blinded by self-interest. When asked what was the most effective method of distributing annuities, more CEOs voted for "banks" than any other category.

On February 14, *The New York Times* reported that the Blackfeet National Bank of Browning, Montana—the only bank owned by American Indians—is taking advantage of an obscure provision in the tax code and will begin offering a certificate of deposit/annuity that would receive the same tax-deferred treatment as a regular annuity. In addition, it would be covered by the FDIC.

Given the choice, we'd probably choose the Blackfeet CD/annuity over the Nurse's Guaranteed Retirement Savings Plan any day of the week. ■

Sell the Sizzle

Truth in advertising?

"Hot annuity prospects are actually calling me!" said a recent ad in an insurance publication. "14.95% guaranteed first year yield," trumpeted another. Since 14.95% is the sort of yield one hasn't seen a lot of since the early 1980s, we assumed there was a catch. (There was. The fine print states that after the first year the interest rate will never be less than three percent.) A broker selling the Accumulator 10—the name this annuity goes by—will not only receive "high commissions," but "tax deferred stock options in a publicly traded company," as well.

A more dignified ad, placed by Transamerica, introduces the new Power Plus℠ annuity by saying that the idea behind it "came to us on the way to work: an annuity that's personalized...[and] loaded with a broad range of liquidity options." Not only does Power Plus℠ offer an interest rate "among the highest of any Transamerica product of its kind," it provides the broker "with a higher commission rate."

Another ad, this one by "America's leading annuity distributor," recommends that investors who've made high returns in the stock market "lock in their gains" by buying annuities. Why annuities? "Freedom from market risk..." In addition, annuities offer the broker "generous commissions."

In *its* ad in the same publication, LifeUSA refrains from offering an opinion on the stock market. It simply says "beat the low interest blues" and get "6.5% guaranteed for one year, 6% mini mum guarantee for five years. Clean, simple and easy! No tricks! No gimmicks!"

Lamar Life doesn't bother with the high-yield approach in a two-page ad for its CLASS *(Comfortable Living and Solid Security)* life insurance program—a "tax efficient retirement income plan designed specifically for boomers." Instead, it opts for a scare tactic. Its headline says, "the organization that predicts there'll be no Social Security"—the American Association of Boomers—"exclusively endorses" Lamar Life and CLASS "to provide security for the 76 million boomers who may soon face retirement without Social Security."

Step right up and get 'em while they're hot. ■

Conseco's Leveraged Life Insurance Acquisitions ($ millions)

Conseco

Date	Company	Purchase Price
1982	Security National Life	$ 1
1983	Consolidated National Life	4
1985	Lincoln American Life	25
1986	Lincoln Income Life	32
1987	Bankers National Life	118
1987	Western National Life	262
1989	National Fidelity Life	68

Conseco Capital Partners, L.P.

Date	Company	Purchase Price
1990	Great American Reserve	$135
1990	Jefferson National Life	171
1991	Beneficial Standard Life	141
1992	Bankers Life and Casualty	600
	Total Purchase Price	$1,047
	Total Equity Invested	$99.5
	Total Debt	$947.5

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Do You Sincerely Want to Be Rich?

Western National Life—Conseco's greatest deal

Conseco, an Indiana-based life insurance holding company and a major player in the annuity business, has achieved growth that can only be described as stunning. Since 1983 its assets have increased from $12.3 million to $14.5 billion, its shareholders' equity has grown from $3 million to $1.2 billion, and its earnings have soared from $300 thousand (2¢ per share) to a projected $235 million ($7.05 per share). The stock has zoomed from $1¾ in 1985 to a recent price of $60.

Conseco started with the premise that it was cheaper to buy than build. After acquiring companies with seasoned blocks of business, it slashed expenses and enhanced the yield on investments. While it wasn't the first company to make leveraged insurance acquisitions, it has probably been the most successful.

Much of Conseco's apparent success can be attributed to one deal, the acquisition of Western National Life Insurance Company, bought from Beneficial Corporation in 1987 for $264 million, $235 million of which was borrowed. On February 11, 1994, in an offering underwritten by Merrill, Lynch and others, Conseco, through its subsidiary Bankers National Life, sold half its Western National position at $12 per share. All told, Conseco's $29 million equity investment has grown to something over $665 million.

The success of Conseco's early acquisitions (see chart on page 2) led to the formation of Conseco Capital Partners, L.P. in 1990. The Confidential Offering Memorandum for this leveraged buyout fund stated that investment opportunities existed because, among other reasons, "life insurance companies generally have not made extensive use of debt financing to support growth or acquisitions."

Conseco Capital Partners leveraged the $99.5 million it raised (half of which came from Conseco) and acquired four insurance companies for $1.05 billion (see chart on page 2). To date, the total return on these investments has been excellent, but nothing like the 2,000% return on Western National.

Based on this continuing success, Conseco Capital Partners II, L.P. recently raked in $623.8, which it will use to acquire life, health, and annuity companies. Assuming ten-to-one leverage, the partnership can spend in the neighborhood of $7 billion acquiring insurance businesses.

Titillating Accounting

Despite Conseco's seeming prosperity, its accounting methods have generated considerable controversy. Abraham Briloff, a noted professor of accounting, complains that Conseco's "present-value-of-purchased-business accounting" distorts reported results by front-end loading income in the early years. "It's one of the most challenging accounting situations I've ever encountered," says Briloff. "I can't help but feel that in all too many ways there's been an aggressive tendency to produce numbers that would be titillating to the financial community."

There's no question that the numbers have titillated Wall Street, where, over the years, Conseco and related entities have raised billions of dollars. Yet the transactional nature of Conseco's operations makes analysis difficult. For example: Conseco Capital Partners' three acquisitions in 1990-91—Great American Reserve, Jefferson National Life, and Beneficial Standard Life—were consolidated on Conseco's financial statements until July of 1992, at which time they were renamed CCP and a thirty-one-percent stake was sold to the public in a deal that raised $111 million.

Bankers Life, which was acquired by Conseco Capital Partners on October 31, 1992, was consolidated on Conseco's 1992 year-end financials, then carried on the equity basis in the first quarter of 1993 after an initial public offering raised $374 million for Bankers. On September 30, 1993, however, Conseco increased its stake in Bankers to 56% and, once again, consolidated it on the books. Briloff's beef is that this whirlwind of activity masks Conseco's operations and makes analysis of the company's numbers from one period to another virtually impossible. Without consistency and comparability, he says, there can be no understandability.

To some, Hilbert's bravura performance inspires confidence. Others see false humility and the silver-tongued spiel of a side-show shaman.

Although Briloff, a buttoned-down moralist who has been called the conscience of the accounting profession, has never met Stephen Hilbert, Conseco's chairman, it's unlikely that he would have more confidence in Conseco's financials after such a meeting.

Despite his bland looks, balding pate, and oversized glasses, Hilbert is a flashy promoter. He sports $3,500 Bijan suits, gets around on Conseco's corporate jet, and, when delivering his smooth, polished sales pitch, speaks with an air of *absolute* certainty. He brashly projects huge growth rates for his companies—which he says are a "vehicle" (pronounced "*vee*-hickel") for capital gains.

To some, Hilbert's bravura performance inspires confidence. (Conseco Capital Partners, L.P. II has attracted such big-name investors as Allstate, DuPont, the State of Michigan, and Ford.) Others see false humility and the silver-tongued spiel of a side-show shaman.

The less skeptical—and henceforth bullish case for Conseco—is that it's a low-cost operator that knows how to buy companies and wring profits out of them—that access to capital and acquisition know-how will allow it to create value and thrive in niches of the insurance business.

The bullish case on Western National—at least as it was relayed to us by various brokers who participated in the offering—is that it's well positioned for growth. Its main business is the sale of single-premium deferred annuities (SPDA) through financial institutions, primarily banks and thrifts. The average customer is sixty-two years old, and the average premium per policy is $15,900.

continued

Because of favorable economic and demographic trends, annuities have been the fastest growing segment of the life insurance industry. Since 1970, industry-wide annuity premiums have grown at an average annual rate of more than twenty percent. (Nonetheless, the annuity business is not our cup of tea, partly because it relies on a tax gimmick, and partly because it invariably attracts the fast money crowd.)

The annuity business is easy to understand. The insurance company pays a commission, receives a premium, makes investments, and credits the annuity holder at a certain rate. The profit equals the spread—the difference between what it makes on its investments and what it credits the annuity holder—minus expenses. Assuming that the spread exceeds the costs, then the greater the annuity liabilities the greater the profits. (When the spread fails to exceed the costs—and this happens to insurance companies from time to time—it's an ugly sight.)

Western has ridden the crest of the annuity wave, and its assets have almost quadrupled in the last six years, to $8.6 billion as of September 30, 1993. Looking ahead, Western's investment bankers project earnings to increase 150% by 1998, to $3.90 per share.

With such a bright future ahead of Western National, one can't help but ask the obvious—why did Conseco sell half its shares? The prospectus implies that growth in the financial-institutions market may depend on Western's ability to garner more favorable ratings. (Western is rated "A" by Best, "A+" by Standard & Poor's, "AA–" by Duff & Phelps, "Baa2" by Moody's, and "C" by Weiss.) It seems that Conseco's presence is a hindrance in this regard. "One factor cited by rating agencies in connection with their ratings of Western," says the prospectus, "has been Conseco's ability to influence the capital structure of Western in connection with Conseco's acquisition strategy." In other words, rating agencies cling to the old-fashioned notion that leveraged acquisitions work both ways—that they can lose money as well as make it.

This may or may not be the reason Conseco cashed in half its position at 6.8 times 1994's projected earnings, three times 1998's projected earnings, and at a price approximating book value. Another possibility may be that, having fattened up the company and accounted for it in a clever manner, it was time for the kill.

Indeed, a chart of Western's first year SPDA premiums would look like a roller coaster. Sales grew from $331 million in 1988 to $1.1 billion in 1991, but shrank to perhaps $450 million in 1993 as a result of increased competition from other carriers as well as from alternatives such as variable annuities and mutual funds. (Western expects SPDA sales to pick up in 1994, partly because of new agreements with U. S. Bancorp., Shawmut National, and Chemical Banking.)

Despite the NALU's opposition to the entrance of banks into the insurance business, it seems inevitable that banks will someday be in the annuity business. If that comes to pass, Western "could be faced with increased competition in its markets or the loss of certain marketing relationships," the prospectus dryly notes.

Western is also vulnerable—as virtually all issuers of SPDAs are—to a significant rise in interest rates. Although Conseco (which manages Western's investments) is, by most accounts, a savvy investor—it pretty much avoided junk bonds and mortgages in the 1980s—it is, in the words of one insurance company president who admires them, "a bull market player." Furthermore, thirty-four percent of its fixed-income portfolio is rated "BBB–," "BBB," or "BBB+"—not junk, but just above it. While there's absolutely nothing wrong with this—or with junk bonds, for that matter—it does indicate that the company may be stretching for yield.

And it might get even worse. After all, what's a company like Western really providing? It invests money at seven percent and credits its customers five percent. While that 200 basis-point spread may be efficient for the insurance business, it pales besides the low costs of no-load mutual funds, which typically charge about forty basis points. The annuity's only real advantage is its tax deferral. But if banks could sell their own annuities—especially variable annuities that offered no-load bond funds—they could save customers *at least* fifty basis points.

Furthermore, is Western National's infrastructure really so cost-efficient and valuable? We're sure its 150 back-office employees in Amarillo do a fine job, but we're also sure that a well run bank or mutual fund organization could do just as well, if not better.

Perhaps Western National's and Conseco's success will continue unabated. As they have proved, you can make a lot of money buying life insurance companies with borrowed money, especially during a period when interest rates are falling.

There is, however, an old saying on Wall Street: don't confuse a bull market with genius.

Stephen Hilbert—and especially his investors—may do well to ponder that. ■

Western National's "Deceptive" Memo

Incomplete disclosure on ratings

THE FEBRUARY ISSUE of the *Insurance Forum* contained a memo from Western National Life's marketing department to its agents summarizing its ratings. Joseph Belth, the editor of the *Insurance Forum*, believes that the memo was deceptive for three reasons.

First, Western said that only thirteen percent of the insurance companies rated by Best received a rating higher than Western's "A." The thirteen percent figure was derived by including companies rated "NA" (rating not assigned). In actuality, twenty-seven percent of the companies receiving a rating were rated higher than Western.

Second, the memo said that it provided "all of the current Western National Life ratings," but didn't include Moody's "Baa2" (Adequate) or Weiss' "C" (Fair) rating.

Finally, although Western's memo listed each rating agencies' "definition" for various rating categories, these definitions had been edited to cast Western in a favorable light. For example, Western defined Standard & Poor's "A+" rating as "secure claims-paying ability and good financial security," but left out the following caveat: "but capacity to meet policyholder obligations is somewhat susceptible to adverse economic and/or underwriting conditions."

Belth wrote to Western and asked about the omissions in the definitions. Western responded by saying that "our Field Update publications are intended for the sole use of, and are distributed only to, our... agents...These summaries [were not] intended for clients."

Belth's response: "Outrageous...Information is deceptive if it gives recipients an erroneous impression of important relationships...A company has an obligation to provide nondeceptive information to all its constituencies, including its agents."

Indeed.

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Vol. 1 #15 **Feb. 7, 1994**

Inside

Financial Disclosure Statements have been filed on both sides of the California pay-at-the-pump battle, revealing the scope of spending and where the money came from. **Page 3**

Best Commercial Markets Over Time: Ranking of states by average profit margins since 1985. **Page 7**

Commercial Auto Profits 1992-1985. Page 6

The Grapevine

An opportunity for non-standard writers may be developing in **Mississippi**. The **House of Representatives** has passed legislation strengthening the enforcement of the state's motor vehicle responsibility laws. **H.1095,** sponsored by **Rep. Ann Stevens** and others, hits drivers with a $1,000 fine, in addition to license suspension, if they are involved in an accident and fail to show financial responsibility either through a bond, a certificate of deposit, or insurance. The fine can be lowered to just $100 if the driver purchases insurance. A spokesperson for Rep. Stevens said it is expected the **Senate** will not go along with the bill as currently drafted, and the legislation will wind up in a conference committee. AIR

Auto Insurance Continues To Stay Outside Clinton Health Care Plan

When the Clinton health plan was just a rumor last fall, it seemed the health insurance portion of auto insurance would escape merger into a universal health system. Now, after months of battling and enough studies to fill the Library of Congress, it appears that original position will stand, and auto insurers will get to keep their slice of the business. (AIR, 10/25/93, P1)

Further, there are side benefits to the implementation of the Clinton plan that could save auto insurers billions of dollars.

Now all insurers have do to is to make this scenario comes true, and that will require continued battling.

Auto insurers are advancing many arguments for keeping auto insurance separate. Some worry about insolvencies, others about escalating law suits, others about

Please see CLINTON on Page 2

Illinois: Favorite Example For Light Regs, Heavy Competition

Ask auto insurers what they like best about the **Illinois** market, and you almost always hear "open, competitive environment." Ask the insurance department the same question, and you hear the same answer: "open, competitive environment." When regulator and regulated are singing from the same page, you usually get good news. In this case, an almost total lack of regulatory intervention in rate setting (and a population that sues less than many other large states) has created a fiercely competitive environment.

Here's the good news:

• Premium rates are low for consumers, ranking 22nd in the nation despite the presence of a giant urban center, Chicago. Those rates look especially good to a state with average income ranking around 9th in the country. Of the top 10 states in total premiums, only Ohio has lower

Please see ILLINOIS on Page 5

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Let's Face the Music and Dance

Why does an insurance company that faces an "unreasonable risk of insolvency" still have an "A–" Best rating?

At the annual meeting of the American Life Convention sixty years ago, A. M. Best's ratings were the hot topic of conversation. Life insurance companies felt that agents were using the ratings to raise solvency issues, thereby undermining the public's confidence in the life insurance industry. The insurance companies decided that there was only one practical solution—get rid of comparative ratings.

On September 28, 1934, a special committee of the Convention met with the Alfred M. Best Company and virtually demanded that it stop issuing ratings for life insurance companies. On November 3, Mr. Best responded by letter, saying, "we recognize that low ratings, however well deserved, create a sales resistance for the companies issuing them; but we also know that such ratings fairly reflect the position of such companies..."

Best wrote that his controlling consideration was "the general good," and that this "both justifies and requires the issuance of the ratings for the protection of the public." Alfred M. Best Company also sent a letter to its subscribers (see below) in which it nobly stated that "it is our duty to continue these ratings, and this will be done."

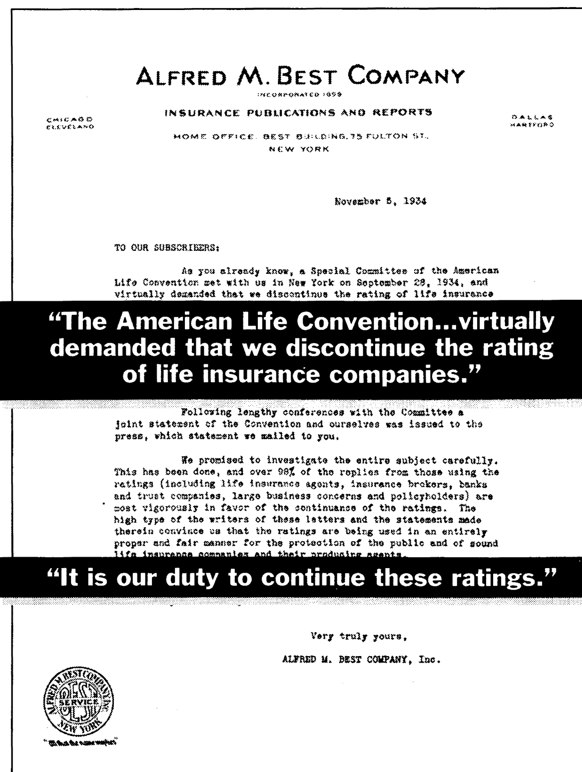
Despite these pronouncements, Best buckled under the pressure the following year and began using words ("Superior," "Excellent," etc.) rather than letters to describe life insurance companies. Letter ratings weren't resumed until 1976.

While this episode is ancient history, Best is still loath to offend the companies it rates or shake things up too much, and as a result, is doing a disservice to its subscribers. One specific situation is Prudential Property & Casualty (PRUPAC), which we mentioned in the Autumn 1993 issue.

You may recall that PRUPAC suffered $1.3 billion in losses from Hurricane Andrew, and that this more than wiped out the company's surplus and prompted a $900 million capital infusion from its parent company to restore solvency.

The state of Florida subsequently enacted a moratorium on cancellations and non-renewals that prevented PRUPAC (and others) from reducing their exposure in areas such as Dade and Broward counties, where they had an inordinately high concentration of hurricane risk. PRUPAC sued, claiming the state's actions exposed it to "an unreasonable risk of insolvency."

Despite this risk, A.M. Best did not lower PRUPAC's "A–" rating, which prompted us to ask: how can a company that, by its own admission, is exposed to "an unreasonable risk of insolvency" command an "A–" rating? (Best's says "A–" companies "have a strong ability to meet their obligations to policyholders.") Wouldn't a "C+" rating, which means that a company has a current ability to meet its obligations, but is very vulnerable to unfavorable changes in underwriting or economic conditions, be more appropriate?



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November 5, 1934

TO OUR SUBSCRIBERS:

As you already know, a Special Committee of the American Life Convention met with us in New York on September 29, 1934, and virtually demanded that we discontinue the rating of life insurance

"The American Life Convention...virtually demanded that we discontinue the rating of life insurance companies."

Following lengthy conferences with the Committee a joint statement of the Convention and ourselves was issued to the press, which statement we mailed to you.

We promised to investigate the entire subject carefully. This has been done, and over 98% of the replies from those using the ratings (including life insurance agents, insurance brokers, banks and trust companies, large business concerns and policyholders) are most vigorously in favor of the continuance of the ratings. The high type of the writers of these letters and the statements made therein convince us that the ratings are being used in an entirely proper and fair manner for the protection of the public and of sound life insurance companies and their producing agents.

"It is our duty to continue these ratings."

Very truly yours,

ALFRED M. BEST COMPANY, Inc.

In 1934, Alfred M. Best told the American Life Convention to shove it...although not in those words.

Jack Snyder, Best's senior vice-president discussed this issue with us last August, just as the hurricane season was getting underway. He said PRUPAC's rating wasn't lowered because he expected the situation to be resolved soon. "If, on November 15, PRUPAC isn't allowed to move forward with its plan, it will not be an 'A–' company."

November 15 has come and gone, and PRUPAC has not yet reduced its exposure significantly. Approximately 3,000 of its 30,000 policyholders in Dade and Broward counties have accepted PRUPAC's offer to pay them a year's premium if they place their coverage elsewhere. This has reduced the company's Probable Maximum Loss to about $1.35 billion, still almost twice its surplus and far more than the $400 million PML it's shooting for. Nonetheless, PRUPAC is still an "A–" company.

We spoke with Snyder in early February and reiterated our concerns. Although PRUPAC will probably be able to reduce its exposure in the future, wouldn't it be appropriate for Best to lower or suspend its rating? The rating could be raised if and when PRUPAC reduces its hurricane exposure.

Snyder is well versed on the subject. "We've been in constant communication with PRUPAC," he said, taking some time to outline the situation. "It would be destructive to all policyholders if we downgraded it." He said such action would make agents and policyholders "very nervous" and "needlessly cause potential movement."

Yes, agents might be nervous if their "A–" company became a "C+" company, and, yes, policyholders (especially those outside of Florida) might consider replacing their coverage with another carrier, and that might weaken the company further. But that's not Best's con-

cern. Their job—"duty," as Alfred Best called it—is to protect the public by issuing ratings. This should be done without considering whether agents, policyholders, or insurance companies are going to be upset. Shouldn't Best put the interests of its subscribers before those of agents, policyholders and insurance companies? And what of *prospective* policyholders: don't they need to be warned that PRUPAC is currently in a dicier situation than a run-of-the-mill "A–" company?

"It's a very complicated issue between the insurance commissioner, the public, and the rating agencies," Snyder said. "Determining what's a prudent course of action by everybody isn't simple. We're working with PRUPAC. But should we have taken them down last fall?" he asked rhetorically. "It's a timing issue." By that he meant that the situation would be worked out over the next couple of years, or even sooner.

Yes, Best should have taken PRUPAC down last fall. Once Best became aware that PRUPAC was subject to much larger exposures than it had previously thought—exposures that could jeopardize the company—Best should have acted immediately. A rating agency does itself and the public no good by pulling its punches.

By taking a Panglossian view of insurance companies (most are rated "superior" or "excellent"), by not placing its subscribers' needs first, by failing to speak out when the emperor has no clothes, and by playing the role of diplomat rather than of rating agency, Best has lost its once impregnable leadership position in the insurance rating business.

In 1935, Best caved in after the life insurance companies turned up the heat. Now, in the 1990s, it seems that Best caves in *before* the heat is even turned on. ■

Rater Rips Berkshire

Standard & Poor's glaring glitch

Standard & Poor's provides "claims-paying ability" ratings for about 650 insurance companies. To receive a claims-paying rating a company must pay $25,000, furnish information, and meet with Standard & Poor's analysts. Those that *don't* go through this process may receive one of three "qualified" solvency ratings—"BBBq" (adequate or better), "BBq" (may be adequate), "Bq" (vulnerable). Standard & Poor's derives these ratings by applying statistical procedures to statutory financial data. No subjective judgments are made.

Unfortunately, these qualified solvency ratings aren't always discerning. A case in point is Berkshire Hathaway's insurance group, which may just be the strongest bunch of insurance companies in the world. (Its main subsidiary is National Indemnity Company.) At year-end 1992, Berkshire's statutory surplus was in the neighborhood of $10.4 billion—three-and-a-half times the company's $3 billion of reserves and fourteen times 1992's $740 million in premiums. Despite this undeniable powerhouse balance sheet, Berkshire's insurance group is rated "BBq" by Standard & Poor's. (A.M. Best rates Berkshire "A++.")

We asked Alan Levin, director of Standard & Poor's ratings group, to explain.

"The rating needs to take a lot more into consideration than just the surplus," he said. "We have a process where we try to look at each company in the same way based on an objective evaluation of information." He pointed out that Berkshire's pure loss ratio was over 100% and that most of the company's surplus is in common stocks.

Both statements are true. Berkshire had about $11.5 billion of equities at year-end 1992 ($3.9 billion of Coca-Cola, $2.2 billion of GEICO, $1.5 billion of Capital Cities, $1.4 billion of Gillette, as well as others), $2.2 billion of bonds and preferred stocks, and $470 million in cash. Even if the value of Berkshire's stocks were to decline fifty percent, its surplus would still dwarf its total reserves.

As for Berkshire's loss ratio exceeding 100%, that, too, is inconsequential. In 1992, Berkshire's combined underwriting loss was $109 million, but net investment income was $355 million. Even if Berkshire had no investment income, it could lose $100 million per year for 100 years before running out of surplus.

We posed another question to Alan Levin: are loss ratios and a concentration in equities really significant in this case, in which the company has such an abundance of capital?

Levin admitted that he was an admirer of Warren Buffet (Berkshire's chairman and controlling shareholder) and even pointed out that Standard & Poor's gives Berkshire Hathaway's senior debt a "AAA" rating. Nonetheless, he refused to budge from his position. "We think it would be unfair to apply a separate yardstick to Berkshire," he said. "We can't make an exception. I don't have a way of putting the positive elements about them into our rating. We can't play favorites; we have to be objective—it would hurt some other company that hasn't had the opportunity to impress us with its character."

But what if by consistently applying inflexible criteria you produce the wrong result?

"I don't think we have," he said. "We've made an objective analysis on a consistent basis."

If Berkshire had paid $25,000 for a Standard & Poor's "claims-paying ability" rating, it would, undoubtedly, have received one of the highest ratings, most likely a "AAA." Because it didn't, it has a "BBq."

When the strongest insurer in America receives a "BBq" rating, that doesn't speak well for Standard & Poor's methodology. ■

Big But "Weak": Property/Casualty companies with over $1 billion in assets and a Weiss rating of "D+" or lower

Company	Weiss	Best	Standard & Poor's
Royal Insurance	D+	A–	A–
Aetna Casualty & Surety	D+	A	AA–
North River	D+	A–	A
Reliance Insurance	D	A–	A
Pennsylvania Manufacturers	D	A	—
U.S. Fire Insurance Company	D	A–	A
Insurance Co. of North America	D	A–	BBq

Weiss: D+, D (Weak)
Best: A, A– (Excellent)
S&P: AA (Excellent); A, A– (Good); BBq (May be adequate)

Earthquake Watch

Seismic probabilities

Although Bob Kilcup lives in the Boston area, a lot of his time is spent thinking about earthquakes. Using an array of scientific data and mathematical models, he estimates the probabilities of earthquakes of varying magnitudes occurring in different locations and the potential insured losses that might result. "It's a delicate calculation," says Kilcup, a research structural engineer with Applied Insurance Research, Inc., a Boston-based firm that provides catastrophe risk assessment and loss-modeling computer programs to insurance and reinsurance companies.

Because earthquakes occur so infrequently, predicting their probabilities is an imprecise science. Kilcup examines statistical analyses of historical earthquake activity to estimate the magnitude of past earthquakes, and looks at the distribution of smaller earthquakes to extrapolate the distribution of larger earthquakes.

Applied Insurance Research's proprietary computer model, CATMAP, which has a complete database of U.S. insured property liabilities broken down by five-digit zip codes as well as premium information on more than 2,000 primary insurance companies, can simulate the effects of earthquakes and windstorms and determine the probabilities of various insured loss levels.

Earthquake Insurance Premiums

($ millions)

	1992	1991	1990
California	$524.4	455.1	412.2
Missouri	29.5	25.7	22.4
Washington	21.6	15.8	13.2
Illinois	17.1	17.0	13.9
Tennessee	16.5	15.8	13.9

Source: A.M. Best

Major Earthquakes

Date	Location	Fatalities
1556	Shensi Province, China	830,000
1906	San Francisco	500
1923	Tokyo and Yokohama, Japan	140,000
1939	Northern Turkey	100,000
1963	Skopje, Yugoslavia	1,011
1970	Peru	67,000
1976	Tangshan, China	242,000
1985	Mexico City	25,000
1990	Northwestern Iran	50,000
1994	Los Angeles	55

Kilcup is quick to point out that the seismic magnitude of an earthquake doesn't always correlate with the insured damage it might cause. For example, an earthquake registering 8.0 on the Richter scale along the San Andreas Fault in southern California would probably cause less insured damage than the recent Los Angeles earthquake—which measured 6.6—because the Fault is about fifty miles from Los Angeles.

Although the faults near Los Angeles are thought to be incapable of producing earthquakes above a 7.25 magnitude, the San Andreas Fault, which runs from Mexico to San Francisco, can produce earthquakes up to 8.5. That's not good news for San Francisco, where an earthquake measuring 7.25 is projected to occur, on average, once every seventy-five years—three times as often as in Los Angeles.

As insurance companies react to the recent earthquake by raising their rates, one can almost hear the cries of "price gouging" from grandstanding politicos. Statistically speaking, however, the future probabilities of earthquakes have actually increased. Kilcup explains: "Before an earthquake occurs you're using historical data to predict probability. Looking at Los Angeles, for example, we don't see many earthquakes of 6.5 magnitude or greater, so we might have estimated that as a one-in-100-year event. [Think of the probability as a fraction in which the numerator is the number of earthquakes and the denominator is the number of years: $\text{probability} = \frac{\text{earthquakes}}{\text{no. of years}}$] Since a new earthquake adds to the historical database, we'd have to reestimate.

"Consider the case of Oregon. Klamath Falls recently had two earthquakes of about a 5.0 magnitude—just enough to do a little damage. But they occurred in an area that had no recorded earthquake history—where we previously thought there was just about no chance of an earthquake. Now we have to reestimate the seismicity of that area."

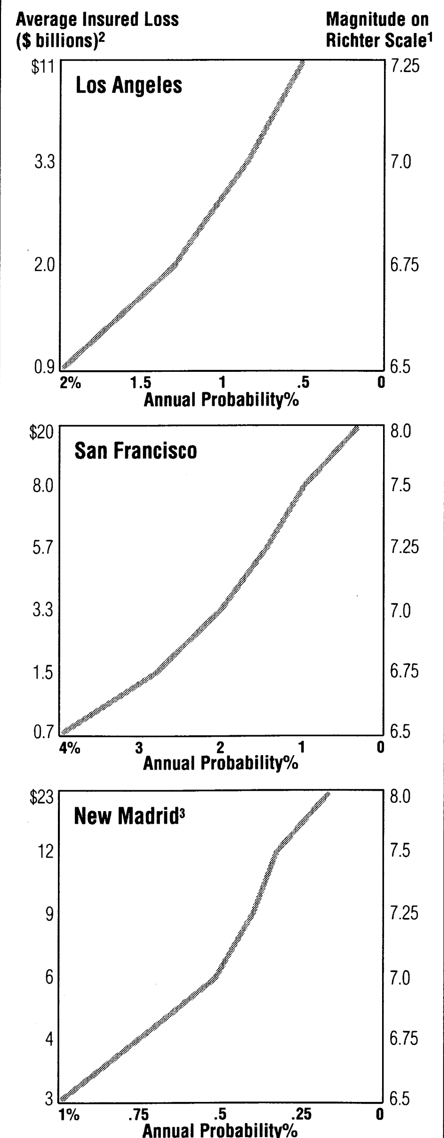
Conversely, each year that an earthquake *doesn't* happen causes the probabilities to decline only slightly, since a change in the denominator has little effect on the equation.

Although earthquake risk has increased, there's so much capital looking to write catastrophe reinsurance that it might not translate into higher reinsurance premiums. Catastrophe underwriters are already grumbling that prices are too low to make money. On the other hand, insurance companies that need extremely high limits of catastrophe reinsurance (e.g. $500 million excess of $250 million) say that the cost of such cover is prohibitive.

Ironically, they may both be right. ■

Earthquake Risk

Average annual loss probabilities for earthquakes of various magnitudes



1 The Richter Scale is a measure of the energy output of an earthquake. Each increment of magnitude (e.g. 6.0 to 7.0) corresponds to about a thirty fold increase in energy.

2 An earthquake of a given magnitude can cause widely varying damage depending upon its location. For example, the average insured loss from an earthquake measuring 7.25 in Los Angeles is about $11 billion, but the actual insured losses might be anywhere from $3 billion to $25 billion.

3 Includes parts of Tennessee, Arkansas, Missouri, and Illinois.

Source: Applied Insurance Research, Inc., Boston, Mass.

Fire Fighting in America

A brief history

In the former Engine Company 30 firehouse on Spring Street between Hudson and Varick, not far from New York City's financial district, stands the six-year-old New York City Fire Museum. Inside resides one of the most comprehensive collections of fire-fighting memorabilia around—engines, pumps, documents, badges, hoses, firemarks, extinguishers, and assorted apparatus.

If you're a fire fighting buff the museum will definitely interest you. But even if you don't give a damn about fire fighting, its *history* should intrigue you because it is closely linked with the history of insurance.

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

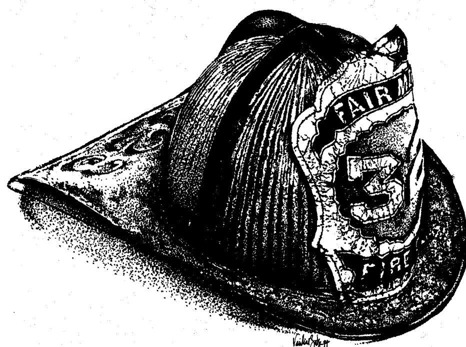
It wasn't until twenty-two years later, though—in response to the destruction wreaked by chimney fires—that the first fire regulations were enacted, in Boston: "Noe man shall build his chimney with wood, nor cover his house with thatch."

In 1623 a fire swept through the little colony in Plymouth, Massachusetts, destroying at least seven dwellings and most of the town's provisions. Governor William Bradford, a Puritan who, we suspect, was not a party animal, blamed the fire on "some of ye sea-men that were roystering in a house."

In 1648, during Peter Stuyvesant's administration as governor of New Amsterdam, the first organized fire fighting began with the appointment of four fire wardens. (Today, New York City has 8,569 uniformed fire fighters.)

In 1659, Boston hired two "bellmen" to stroll through the town from midnight to five a.m. looking for fires. According to legislation, if they saw a fire they were to "give an alarm."

Fire fighting was rudimentary, with bucket brigades the order of the day until 1676, when the city of Boston brought the first "pumper" to America. This technological leap forward led to the formation of the first engine company in America.



The first volunteer fire company wasn't organized until 1736, when Philadelphia's Benjamin Franklin ("Never leave till to-morrow which you can do today") established the Union Fire Company. Fire prevention was of great concern to Franklin. In fact, his oft-repeated maxim, "An ounce of prevention is worth a pound of cure," comes from his newspaper editorial, "On the Protection of Towns from Fire."

Sixteen years later Franklin formed the Philadelphia Contributionship, one of the earliest fire insurance companies. The distinction of forming the first fire insurance company, however, belongs to Jacob Motte of Charleston, South Carolina. In 1736 he started The Friendly Society for the Mutual Insuring of Houses Against Fire. Four years later a disastrous fire put the fledgling company out of business.

Following the British example, by the mid-1700s American insurance companies began issuing firemarks—lead emblems mounted on wooden shields—to mark property covered by insurance. Their purpose was twofold. Not only did they discourage arson, but they signified that an insurance company would compensate a volunteer fire department for extinguishing a blaze. These colorful emblems, which are collectors' items today, were phased out by the late 19th century.

Then, as now, being a volunteer fireman was a prestigious, club-like activity. George Washington, Thomas Jefferson, Paul Revere, Alexander Hamilton, Aaron Burr, and Benedict Arnold all served as volunteer firemen.

The industrial revolution brought about changes in fire fighting. Hand-drawn pumpers could now send out continuous streams of water instead of intermittent spurts. A new hose was designed to withstand greater pressure, and early protective gear, as well as the forerunner of today's fire helmet, came into use.

By the 1850s, horse-drawn steam engines had replaced the old man-drawn and man-pumped engines. In New York City, seven-story watchtowers were manned by fire wardens on the lookout for smoke or fire. In the next decade, several cities installed fire-alarm telegraph systems.

New York City didn't organize its paid fire department until 1865, thirty years after the Great New York Fire of 1835 destroyed 600 buildings, caused $1 million in damage, and bankrupted all but three of New York's insurance companies.

In the 1860s firemen were paid $700 per year and got one day off per month. Department regulations prohibited, among other things, the use of profane language. Firehouses were numerous because the horses that pulled the engines could only run at full gallop for a few blocks.

In 1867 Boston bought its first self-propelled Amoskeag steam fire engine. A fire department report from the time notes that "it did not frighten passing horses any more than did the horse-drawn steamers."

New York City began building its high-pressure water supply system in 1903 and shortly thereafter bought its first motor-driven engines. By 1910, motorized equipment began replacing horse-drawn systems, and in 1922, Engine 205, the last of its kind, made its final run. *The F.D.N.Y. Centennial* commented:

"Thus ended a colorful and glamorous period...Nothing was more thrilling to the old New Yorker than the sight of three beautiful horses straining in the harness, at full gallop, as they pulled one of those magnificent steamers trailing a column of smoke from its highly polished stack. Old-timers knew it well, but alas, the youngster of today can only see it in pictures, without ever really knowing the thrilling sound of the pounding clattering hoofs and clanging bells."

Although fire fighting has changed much since the early days, one element remains the same: it's hazardous, dangerous, dirty work.

Today there are 32,000 fire departments in America, of which 31,000 are manned by volunteer fire fighters, whose ranks total approximately 1,500,000. We take our hat off to them. ■

Bound for Glory: Emerson, Reid's Insurance Observer Is Five Years Old

How an $8 million lawsuit made us what we are.

The first issue of *Emerson, Reid's Insurance Observer* rolled off the presses in March of 1989. It was just a few hundred words of text (current issues average 8,500) and was, in retrospect, worth about what we charged for it—nothing.

Under the captivating headline "A Brief Introduction," I wrote the following: " 'You can observe a lot just by watching,' said Yogi Berra. With that in mind, we are kicking off the inaugural issue of the *Insurance Observer.* We expect to be publishing this periodically—in other words, whenever we get around to it and whenever we have something interesting to say. That may not be too often." At the time I really had no plans for ERIO to be much more than a self-promoting handout for Emerson, Reid & Company, a general agency specializing in New York State Disability, of which I'm president.

Magazine journalism, however, has always been a passion of mine, and when I was in the investment business I'd developed a real appetite for financial journalism, especially the first-rate stuff that regularly appeared in *Barron's* and *Grant's Interest Rate Observer* chronicling the egregious excesses routinely occurring on Wall Street and in the boardrooms of corporate America.

Despite this journalism addiction, I never actually considered being a journalist until the summer of 1988, when, while reading Bergen Brunswig's proxy statement (Bergen is a large, publicly held drug wholesaler) I realized that the two brothers who ran the company had devised a duplicitous and theretofore unnoticed plan that, in effect, paid them $195 a share for their stock. The trouble was, Bergen was selling for $20 a share on the American Stock Exchange. Outraged, I called Alan Abelson, the editor of *Barron's,* described the situation (which I dubbed "reverse greenmail") and asked if I could write about it.

My article appeared eight weeks later, and was a success. Bergen canceled its annual meeting and withdrew the plan. An op-ed column on this issue appeared in *The Wall Street Journal* a short time later.

I began writing for *Barron's* almost every month, generally about some sort of outrageous corporate behavior. I detailed how Mike Dingman and Paul Montrone, the wheeler-dealers who ran the giant Henley Group, had sucked out a virtually risk-free $50 million profit by engaging in a whirlwind series of complex asset shuffles. I described how the senior management and an outside director of Formica had spurned a $20-a-share takeover offer, all the while secretly structuring their own *lower* offer.

My good times with *Barron's* ended in November 1989 when "Junk Art," my article questioning the prospects of three over-the-counter art gallery chains, prompted angry letters from the galleries and, ultimately, an $8 million lawsuit against me and *Barron's.*

Even though Robert Bleiberg, then publisher of *Barron's,* wrote an editorial calling the article "prescient," *Barron's* gave me the old dump-a-roo and refused to defend me or pick up my defense costs, which were considerable.

It would be difficult in this short space to express the sense of disappointment and betrayal I felt towards *Barron's* and, especially, towards Alan Abelson, who at one time had been a hero of mine. Besides, there's an old maxim about not picking fights with people who buy ink by the barrel.

Over the next couple of years the lawsuit was thrown out of the Cook County Court four times. Finally, in 1993, it was dismissed for good. (As for my analysis of the three gallery chains, by 1993 one had gone bust and the stocks of the other two had declined ninety percent and ninety-five percent.)

One upshot of the lawsuit, however, was that the time I'd spent writing for *Barron's* was then devoted to *Emerson, Reid's Insurance Observer.* The results have been far more gratifying than I expected. Our subscribers are a "Who's Who" of the insurance industry, and they've been a wonderful source of information and encouragement.

Along the way I've also learned a thing or two about the publishing industry. Experts have told me that I've made every mistake in the book: ERIO is too hard-hitting for a trade publication, the subject is too broad, the production values are too high, the writing is too polished, the analyses are too in-depth, and finally, it's way too cheap. In other words, I take too much time, spend too much money, and charge too little.

That may be true, but I can't help it. I've tried to create a publication that people would love to read. That's not an easy goal, especially when the subject is insurance, but based upon our subcribers' phone calls and letters, I think we're succeeding.

Thanks for your support.

David Schiff
Editor & Writer

Emerson, Reid's Insurance Observer is now published six times a year.

EMERSON, REID'S
INSURANCE OBSERVER

A&A: You Won't Have Tinsley Irvin to Kick Around Anymore

WHEN TINSLEY IRVIN, the chief executive officer of beleaguered Alexander & Alexander, unexpectedly announced his retirement on January 17, "in order to accelerate the pace of change and effect improvements in operations and earnings," A&A's stock soared. For the week ending January 21, it rose 1¾ to $21, a gain of almost nine percent. Since there are more than 41,000,000 shares outstanding, A&A's market value increased by about $72 million.

One popular view of Irvin's departure is that someone had to take the fall, and since he was the CEO, he got the honor. Irvin, who had been CEO since 1987 and chairman since 1988, admitted that A&A needed to be shaken up a bit. "Some of the old ways we do business must also change...The time has come to change both the leadership and the governance structure of our company." Few would disagree.

One can't help but wonder, though: if the departure of the CEO raised A&A's market value by $72 million, how much would the market value rise if the entire board of directors (which is loaded with insiders) was booted out?

A&A's Art Collection

A&A'S LONG, slow decline can be attributed to many things: bad acquisitions, a soft insurance market, bad management, and maybe even bad luck. That A&A's heady growth in the 1970s was achieved largely through acquisitions might also be part of the problem.

Less well known, but perhaps symptomatic of a certain hubris that may have led to its woes, is the company's art collection. We became aware of the collection about eight years ago when we dropped by A&A's vast corporate headquarters on the Avenue of the Americas in New York City to pick up an annual report. As we sat in the huge, swanky waiting area, we were surprised that there were no magazines, newspapers, or A&A pamphlets lying about. In fact, the only reading material was a nicely printed twenty-four page brochure entitled "The Art Collection of Alexander & Alexander." (We understand the brochure dates back to about 1980.)

While there's certainly nothing wrong with art, and certainly nothing wrong with having nicely decorated offices, it's questionable whether a company that's been reporting terrible financial results for ages should have a fancy art collection in its corporate headquarters. Indeed, shareholders may want to know why the collection has not been sold. (It's possible that the collection has only nominal value, but if that's the case, why would A&A have bothered printing a brochure?)

What's in the collection? Nice stuff. There are seventy-three items from all over the world, and they range from a nineteenth-century Mennonite quilt to fourteenth-century Chinese sculptures. There are oil lamps from Java, some ritual weavings from northwest Borneo, Japanese scrolls, Audubon prints, an English wall clock, some Delft tobacco jars, an American Indian saddle blanket, and much more. "The common bond" among these items, A&A points out, "is that most were created by people for actual use in their daily lives and culture."

We called A&A and asked how much the collection was worth and whether they were planning to sell it. Although they declined to provide us with even a rough estimate, we were told that there are no plans for its sale.

Not yet, anyway.

World Gone Mad

CNA INSURANCE THINKS interest rates are headed higher, and, as a result, is bearish on bonds. Very bearish. Their investment portfolio pretty much speaks for itself. As of September 30, 1993, $8.7 billion of its $24 billion was in short-term maturities. Cash, so to speak.

At a conference a few months ago, Lisa Hess, who manages bond investments for Loews (CNA's parent company), told the audience that the maturities of the company's investments were "extremely short...almost imprudently short. Now is the time to be in the highest quality credit instruments. We think the world has gone insane."

For the record, she was referring to the world of investments.

Reach Out and Touch Someone

WE RECENTLY CONDUCTED an informal survey of insurance company and insurance brokerage headquarters. How many rings did it take for the phone to be answered, was the person polite, and did we encounter a recorded message?

The results surprised us. Usually the phones were answered immediately by a well-spoken person. However, based on past experience, it's unlikely that we'd have such good luck at branch offices.

Phone Test
Number of rings it took to answer phone at corporate headquarters. (V = Voicemail)

Company	Rings
Alexander & Alexander	1
Allcity	V
Allstate	1
Cornhusker Casualty	1
Equitable	1
Farm Bureau Mutual (Idaho)	1
Guardian Life	1
Johnson & Higgins	1
Marsh & McLennan	2
Metropolitan	1
Prudential	1
State Farm	1

Eveready, but Ever Rude

JUST AFTER WE FINISHED our survey, we called the Eveready Insurance Company, a small carrier that writes auto liability and physical damage, and asked to speak to the president. We wanted to know why the New York State Insurance Department said Eveready had the highest ratio of automobile insurance complaints.

After holding for a couple minutes we were disconnected. We called back and asked again. Finally the receptionist came back on the line. "I told him who you was callin' from, and he said he's not interested," she informed us.

Although Eveready answered on one ring, we're not surprised that people complain about them.

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

Not everyone likes *Emerson, Reid's Insurance Observer.*

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 news." You can get that lots of places. Besides, by the time something is news it's too late to do much about it anyway.

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

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- In January of 1990 we said First Executive looked like a goner. A little over a year later it was gone.
- 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.

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