

**New Hampshire Insurance Department Hearing
on Proposed Acquisition of Control
of The Home Insurance Company
by the Zurich Insurance Company
Concord, New Hampshire
April 3, 1995**

**Testimony of Richard E. Stewart
at the request of
Atlantic Richfield Company
and
American International Group, Inc.**

For many years, some of the oldest names in commercial property-casualty insurance have been widely known to be in decline and even to be in trouble.

The proposed transaction that brings us here today is sometimes described as a way of getting those companies out of that trouble and even of stemming that decline.

The proposed transaction is not that at all. I would like to discuss with you what it is. I shall suggest that the Department and a wide variety of people concerned with a healthy and reliable insurance business should worry about this transaction and where it may lead. First a word on my personal background for the testimony.

Personal Background

From 1967-70 I was Superintendent of Insurance of New York and in 1970 was President of the N.A.I.C. This hearing is under New Hampshire's enactment of the N.A.I.C. model insurance holding company law, which stemmed from the report of a study committee I appointed. Two other New Hampshire statutes which are in the background today, the guaranty association law and the unfair claims practices law, are also based on N.A.I.C. models which came from New York laws I originally proposed. You are dealing with situations and statutes with which I have had direct experience, and I hope it will be helpful to you.

After leaving state service, I was General Counsel of Citibank and Citicorp, the largest financial services holding company system in the world, and was an outside director of General Reinsurance Corporation, the largest American reinsurer. For nine years thereafter I was Chief Financial Officer of the Chubb Group of Insurance Companies and a director and CFO of its United Life and Accident Insurance Company, based in Concord.

For the last 14 years I have been at Stewart Economics, a consulting firm specializing in insurance. One third of our work is for insurance companies, often involving acquisitions and restructurings, one third for insurance departments and other government agencies, often on solvency matters, and one third for policyholders, often in coverage disputes. Our work has included two published reports on regulating financial condition and dealing with insurance company insolvency, with emphasis on general liability losses. I will draw on all that experience in this testimony and will examine the proposed transaction from those different points of view.

THE PROPOSED TRANSACTION

Though complicated in its details, the proposed transaction is essentially simple. It has three main parts or aspects worth special consideration.

Separating the Future from the Past

First, The Home's book of business is to be divided into the future and the past. With respect to writing insurance in the future, the renewal of The Home's present or in-force business would be up to the Zurich, which would have the right to comb through The Home's book. The accounts Zurich wanted it would renew into a Zurich company. Those it did not want would have to go elsewhere, for the plan calls for The Home to write no new or renewal business voluntarily.

While the right to issue future renewal policies for The Home's accounts would go to the Zurich, the present and past policies would stay with The Home for all

purposes. The main such purpose is claims against the policies. That is true both as to general liability policies, expired decades ago but with outstanding claims for asbestos and pollution, and as to lawyers malpractice policies written last year. The policies and the pending and future claims against them would be run off in The Home by a servicing subsidiary of Zurich called REM. Since the most prominent segment of those policies consists of expired general liability contracts with large reported claims for asbestos bodily injury or pollution cleanup, I shall refer to the segment as "old claims" or "policyholders with old claims".

This distinction between The Home's policyholders with old claims and its ongoing accounts underlies many concerns about the proposed transaction.

Superficially the separation resembles a reunderwriting or a "good bank/bad bank" rehabilitation plan. But not really. It is a temporal separation; the future goes one way and the past another. The run-off book is mainly expired policies, many with large claims already pending. So this transaction differs from a reunderwriting in that it is not a matter of prediction. It is hindsight. And it differs from a split of business in rehabilitation in that it is not a rehabilitation. It is to be conducted by the acquiring private group, not by the Insurance Department. It is to be outside the laws of rehabilitation which forbid preferences.

Capital for the Run-Off

The second main part of the proposed transaction is the determination that The Home has enough capital to support the run-off of the old claims. Apparently the capital needs are derived from case reserves, bulk reserves and reserves for incurred but not reported losses. Assets to cover the reserves and policyholders surplus are present assets of The Home, including real estate and subsidiaries.

Leaving aside asset quality, the quantity of assets to be assigned is entirely dependent on the amount of the reserve estimates for the old claims, especially the case reserves, and on the amount of credit given for reinsurance recoverable on those claims.

Since many of the large pollution and product liability claims are the subject of coverage litigation, those estimates are very difficult. It is widely believed that the case estimates of The Home's management before the proposed transaction were far too low. How much of the reinsurance will respond is not known.

The Home's 10-K Report states that asbestos and pollution together were reserved at \$403 million gross and \$189 million net, including large amounts as bulk reserve and loss adjustment expense reserve. For a company that has 2,100 policies with open asbestos and pollution claims, those are not reassuring numbers. The likelihood of reserve inadequacy and hence capital insufficiency is of particular concern because of the danger of preferences as among classes of business in what amounts to a private liquidation. The run-off of The Home by REM would include a substantial book of personal lines business, whose claims settle quickly. The personal lines claims would get paid in full even if no money remained for the long-tailed claims such as asbestos and pollution.

Relationships with the Zurich

The third main aspect of the proposed transaction is its creation of a variety of relationships with Zurich entities. They include reinsurance, to be available only when The Home in run-off is out of cash. For this unusual resource The Home is to commute an existing treaty, which may have more substance, and to pay cash. Though the new reinsurance would only perform when The Home ran out of cash, which is years after a liability insurer becomes insolvent on its financial statements, the whole proposed transaction is conditioned on the regulators' granting the new treaty credit as an asset on The Home's balance sheet.

Further relations with Zurich are run-off services, including claims adjustment and coverage determination, by the new run-off entity called REM. That Zurich affiliate is to be compensated on adjustment expense plus a contingency. REM's compensation poses exquisitely the distinction between the interests of a regulated insurance company and the interests of the members of the public who deal with it.

REM is to receive much of its contingent compensation only if The Home is able to pay it at the conclusion of the run-off process. To that incentive to save money by not paying claims is added REM's immunity from the normal business constraint of keeping customers for the future. Policyholders and claimants can expect REM to be a tougher adversary than The Home ever was.

But more important than all the relationships the proposed transaction creates with the Zurich is one it does not. For The Home, as it runs off the old claims, is not to have any recourse to the Zurich generally or any recourse to the future earnings of the ongoing book of The Home's business which Zurich chooses to renew or any recourse to the rest of The Home's ongoing book which the transaction itself causes The Home not to renew.

Purpose and Structure of the Transaction

Based on what we know now it seems reasonable to sum up the business objectives of the proposed transaction as follows.

There appear to be three objectives. First, to identify the profitable accounts and take them out of The Home and into the Zurich. Second, to put the old claims into a separate run-off process with special incentives, and to expend on it as few resources as possible as late as possible. Third, to keep the run-off process under the control of the Zurich rather than the Insurance Department for as long as possible.

Given The Home's situation and the great uncertainty surrounding it, those business objectives can only be achieved by departing from two ideas which heretofore have been basic to insurance and insurance regulation. One is that, when a company is financially precarious, different classes of policyholder and claimant should not be accorded preferential treatment. The other is that the ongoing book of business of any insurance company is one of its principal assets.

The value of the ongoing book is a major component of valuation when insurers are sold. The diversification effect of a broad book of business was the main argument

in favor of multiple line underwriting, and today it is widely believed that a multiple line insurer is more stable than a specialist because the profits from some lines will carry the company through bad times in others. That is a big reason policyholders, brokers, insurance departments and rating agencies have stuck with the great multi-line companies so long.

At any level of abstraction or particularity you choose, it is the essence of the proposed transaction to treat different classes of policyholder differently and to deprive the old claims of any call upon the value of the ongoing business. It could thus be characterized as an open invitation to preferences and to diversions of corporate opportunity.

DIRECT EFFECTS OF THE TRANSACTION

Let us now look more closely at what the proposed transaction means for those most directly affected -- The Home's policyholders, claimants against those policyholders, The Home's competitors and other insurance companies. Later we can look at how the transaction would be likely to affect important but less directly affected constituencies and policy objectives, such as the competitive market and the regulation of insurance.

Long-Tailed Liability Claims

The milestones in The Home's decline will be noted later in this testimony. But the cause of its immediate financial problems is stated to be its heavy involvement in commercial general liability insurance, not at the primary level but at the excess levels. In particular, in the 1950s, 60s and 70s, The Home aggressively wrote an especially broad form of first-layer excess general liability called "umbrella".

Liability insurance policies have a provision which determines whether the policies of a given time period have to respond to covered claims. The provision is called the "trigger", and general liability policies usually are triggered by either an

accident or an occurrence. Both those terms relate to a cause or an effect which can happen many years before a claim is made. That time lag is part of the "long tail" problem of underwriting, rating and reserving general liability. It was a principal cause of the last two liability crises affecting the entire industry, in 1975 and 1985. It was behind the industry's effort in the late 80s to introduce a "claims made" trigger for general liability, like the one common in professional liability, but it did not generally catch on with regulators, brokers or customers.

Policyholders

Now consider the situation of a policyholder with a general liability policy with an accident or an occurrence trigger. Consider especially the policyholder presented with a claim for a kind of harm that takes a long time to become evident, such as asbestos bodily injury. Or a claim under laws that did not even exist at the time the policy was in force and the accident or occurrence took place, such as pollution property damage.

Those are the expired policies to be left to run off in The Home. Vast numbers of claims from the last 40 years of coverage are now in, but the time dimension of accident and occurrence general liability policies is exceedingly long. Should new claims be presented in the future for harms suffered when those policies were in force, those claims too would be for The Home and REM to cope with. Financial provision for them depends on the adequacy of reserves for incurred but not reported losses, the most conjectural of reserving exercises.

The Home's financial reports show large amounts of adverse loss development as claims age. That pattern does not vouch for the adequacy of the reserves the company is putting up now. It suggests trouble ahead, both in the aggregate and in the preference of short-tailed claims over long-tailed ones.

The policyholder, who now has an old, long-tailed claim, originally purchased coverage from The Home with a reasonable expectation of looking to the resources of

an entire group with an ongoing business. That policyholder is now to be shunted off into a condemned company possessing the minimum of resources and managed under incentives not to pay claims. This stunning decline in the policyholder's prospects is to be achieved without its consent and without the promisor, The Home, entering into the one arrangement which our law provides for legitimately defaulting on contracts, and that is rehabilitation and liquidation.

Claimants

Where the policyholder ends up is often where the claimant ends up too. The claimants in the asbestos liability and other mass tort situations are most frequently injured workers and their families. The claimants in the pollution liability situations are most commonly the federal or state governments seeking funds other than tax funds for cleaning up the environment.

Liability insurance has dual objectives, indemnifying the wrongdoer and compensating the victim. Our laws clearly recognize the two objectives for automobile, workplace and medical injuries, and general liability is moving in the same direction. As government evaluates a proposed transaction that may impair an insurance company's ability to respond to claims, it is entirely appropriate to consider the interests not only of policyholders but of claimants as well.

Policyholders and claimants are not, however, the only non-parties to this proposed transaction who would have to bear its costs. The rest of the insurance industry has more at stake than at first appears.

Other Insurance Companies

If The Home in run-off cannot meet its obligations, they will fall in part on other insurance companies. That would happen in two main ways.

The first way is through the interaction of standard policy provisions and the underlying liability law. If, for example, one of several parties responsible for pollution

cannot pay for cleanup, the other parties may often have to pay more. So if a Home policyholder is one of those parties, and neither The Home nor the policyholder can pay, then other policyholders and their insurers may have to. In like fashion, if one of several insurance companies for a given policyholder cannot pay its liabilities, the others may have to pick up that shortfall.

Those are the immediate effects. The indirect transfer of costs from Zurich and Home to other insurers would come through the insolvency guaranty associations. To the extent The Home's unmet obligations were covered by the guaranty funds, the outlay would either be absorbed by the other companies or passed on to other policyholders.

In most states, assessments for general liability insolvencies are not confined to that line, and in some states even personal auto premiums are in the assessment base. The costs of this transaction would spread yet further outward, away from the parties to the transaction and into the community at large, as the assessments were loaded onto unrelated policies, deducted from federally taxable income and credited against premium taxes in many states.

BROADER EFFECTS OF THE TRANSACTION

More harmful to insurance companies, and ultimately to the public, than the direct charges under liability policies and guaranty funds would be damage which transactions of this sort would do to competition in insurance markets. They would do so by encouraging healthy companies to discard losing accounts after claims emerge and by encouraging troubled companies to pursue competitive strategies prone to disaster.

Courting Disaster as a Competitive Strategy

Nothing about the proposed transaction limits it to failing or even declining companies. All it requires is one insurance company, the target, with sizeable long-

tailed liabilities that it would like to get rid of, and an acquiring company that would like to have the target company's customers, or at least the privilege of picking through them, if it could do so without taking on the long-tailed liabilities.

The description of the target fits a great many casualty insurers today. And the same principle applies to other situations in which a company would like to be rid of some commitment that did not work out, and a potential acquiror would like to get the profitable parts of the target if it could weed out the unprofitable ones.

Underwriting general liability is only one way a company can take on exposures that pay off handsomely when they work out and become identifiable disasters when they do not. Property and surety underwriting can do it, as can investments and reinsurance. Mission Indemnity might be thriving today if it could just have split its book and sent the defaulting reinsurance into a separate run-off. Even Transit Casualty might still be around if it could only have sloughed off the business it got from managing general agents.

One conclusion from the federal misadventures with the S&Ls, from the junk bond and real estate failures in life insurance and from the casualty company failures due to weak reinsurance is that government should not encourage managements of fiduciary businesses to take catastrophic risks and pursue disaster-prone strategies. One way government encourages such behavior is by providing a way for managements and owners to walk away from the consequences when such a strategy fails, while externalizing the costs onto customers, competitors and taxpayers. That is a great danger of the pending transaction, especially were it to become a template for responding to insurance and investment disasters.

For a competitor, that is a dismal prospect. It is widely believed that the commercial property-casualty industry is subject to chronically depressed earnings because its products are undifferentiated commodities, competitive only on price or relaxed underwriting. The worst kinds of price competition come from people who sell below their own costs just to get business, and from people who take on catastrophic

risks without charging for them. To a competitor, that is what The Home has looked like for a long time, and a way of walking away from the consequences is what the proposed transaction looks like now.

How The Home Got Where It Is Today

Let me document that last point, about The Home's courting disaster for a long time and doing so as a conscious business strategy. It is important to see that the company's decline has been a process, not a single event, and that it has had little to do with bad luck or Acts of God.

At the beginning of World War II, the largest property-casualty insurer in the United States was The Home Insurance Company. The Home was a high cost provider, which tried to reduce costs by paying its employees famously low salaries. The company's well being depended on the fire insurance bureau or cartel system of fixing prices. The decline of that system since World War II has been the most important and best known event in the whole insurance field.

In the 1950s and 60s and into 70s, The Home was the domestic market's most conspicuous seller of umbrella coverage, the broadest form of commercial general liability insurance. That amounted to a huge bet against expansion of the American tort system.

In 1968 The Home was taken over, in a reasonably friendly transaction, by a real estate investment company. In 1969, The Home paid to its new parent the largest single dividend in insurance history. That happened when the New York Insurance Department's holding company bill was pending in the state legislature, and it certainly speeded passage and stimulated the N.A.I.C. to put teeth in the model bill. The Home's holding company also exchanged assets with the insurer, endowing it with real estate that is still there and relieving it of investment grade bonds.

All that activity took place while the company was still domiciled in New York, where it had been since before the Civil War. In 1973, The Home's parent found New York regulation too confining and moved the insurer's domicile to New Hampshire.

In the 1980s, The Home came under the practical control of a law firm in constant controversy for allegedly abusing its clients. In recent years and today, The Home has been an aggressive seller of excess general liability and professional liability coverages, which produce good early cash flow but give rise to very long-tailed claims.

The point of that corporate saga is that The Home has been in a steady decline for fifty years, hastened by some big marketing gambles and by the exploitation of the company by others for their benefit and not its own.

The final party in interest in this affair is state regulation of insurance. It is quite proper for a regulator to consider the long-term interests of his own institution as well as the interests of others.

State Regulation

Merely by being proposed, this transaction puts on the spot any regulatory agency that has to deal with it. After all, if on a properly reserved basis The Home is insolvent, then the rules say it should be placed in rehabilitation or liquidation, and diversion of its best business is the last thing that should be allowed. If, on the other hand, The Home is all right, then the proposed transaction should be evaluated under the holding company laws as a buy-out, and its preferential features evaluated under the holding company laws just as would be done for any other deal between healthy companies.

A fascinating aspect of the proposed transaction is that it is being presented as a bit of both. On the one hand, it is not proposed that the transaction be evaluated under the prohibitions against preferences that apply to bankruptcy. On the other, it is said that the train is leaving the station, and that if this proposal is not approved The Home will crash forthwith.

The awkwardness of the proposed transaction for any regulator is underscored by some final concerns about it and about the regulatory process.

One is that the present regulatory system contains many incentives for a regulator not to suffer a failure on his or her watch and to forbear and wait and delay. Our firm has written about it in recent years, and the two of us who were commissioners have experienced it first hand. Another concern is also widely remarked, especially in Congress. It is that state regulation and the state guaranty funds may be too fragmented to take on a large, multi-state insolvency centering on complex liability insurance.

What others may think is hardly a reason for turning down an otherwise good proposal, but it is a good reason to approach it with all the care you can. That is particularly true because of one appearance which this transaction cannot shake. It is that the regulators are being asked to favor one regulated business entity, its management and its owners, and another regulated business entity acquiring it. The regulators are being asked to favor them over the policyholders, the claimants and the long-term health of the insurance market and insurance regulation.

That appearance springs from the structure of the proposed transaction and from the regulatory accommodation that is requested for it. Both the structure and the accommodation have been described in this testimony. To summarize: the structure has two flaws. One is that it gives The Home and its present and past policyholders no call upon the value of the company's ongoing book of business but, instead, gives that value to the Zurich. The other structural flaw is that the proposed transaction would keep the liquidation of The Home in private hands, free of the laws against preferring one policyholder over another. The requested regulatory accommodation is, as a practical matter, to put this one company's solvency regulation on a cash basis rather than an accrual and financial statement basis like all the others.

Perhaps an abundance of real, new money could overcome those structural flaws in an imperfect world, but one cannot help suspecting that the flaws are there because the money is not.

The proposed transaction's one, unshakable appearance – the appearance of favoring the regulated business over those who depend on it and on a fair marketplace – is reason enough to require a lot of practical strength behind this transaction. It is reason to require, specifically, that The Home in run-off either have a call on the Zurich or on the ongoing book of business being renewed in the Zurich or, at the very least, that after examining The Home's case reserves and IBNR and its old and new reinsurance, the Department is certain that The Home in run-off can meet the obligations it has already taken on. If error is inevitable in those estimates, it should be on the side of having too much rather than too little. Failing that, I would respectfully suggest that the existing statutes are there to be used, not avoided.

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