

# The Tragedy of Corporate Governance in America

## *Impacts and Implications for the Insurance Industry*

Casualty Actuarial Society of the Northeast

Uncasville, CT

September 30, 2002



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Robert P. Hartwig, Ph.D., CPCU, Senior Vice President & Chief Economist  
Insurance Information Institute ♦ 110 William Street ♦ New York, NY 10038  
Tel: (212) 346-5520 ♦ Fax: (212) 732-1916 ♦ bobh@iii.org ♦ www.iii.org



# *Serious Implications for Financial Institutions*

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- **Insurers exposed to a wide variety of risks:**
  - **Investment risk (as institutional investors)**
  - **Insurance risk (surety, D&O, E&O, etc.)**
  - **Litigation risk (as both plaintiff & defendant)**
  - **Regulatory risk**

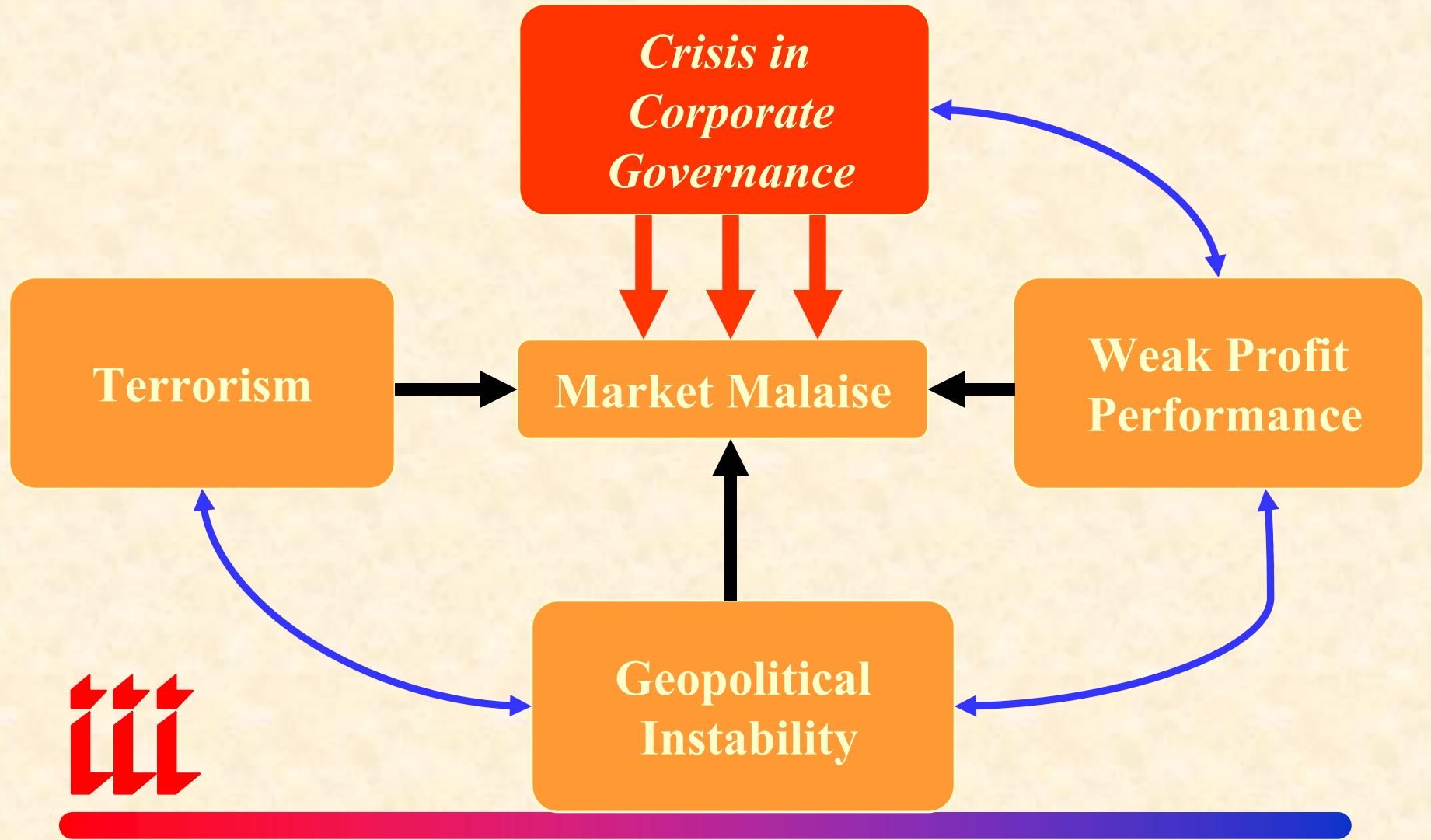


# *Corporate Governance: Expensive and Hard-Learned Lessons*

- **Crisis of Confidence—skepticism is on the rise**
  - Ratings agencies      Analysts      Regulators
  - Investors/Creditors      Employees      Lawmakers
- **Regulatory/Legislative Fallout Unclear**
  - Enormous number of investigations under way
    - SEC, State Attorneys General, IRS, DoJ, etc.
    - Most new SEC cases are against large companies
  - Many competing reforms from Congress, SEC, A.G.'s., NYSE, NASDAQ, etc.
  - Collectively are likely to help, at least somewhat
- **SEC, Administration & Congressional proposals vary**
- **Surge in shareholder suits well underway**



# *Market Malaise*





# Houston...

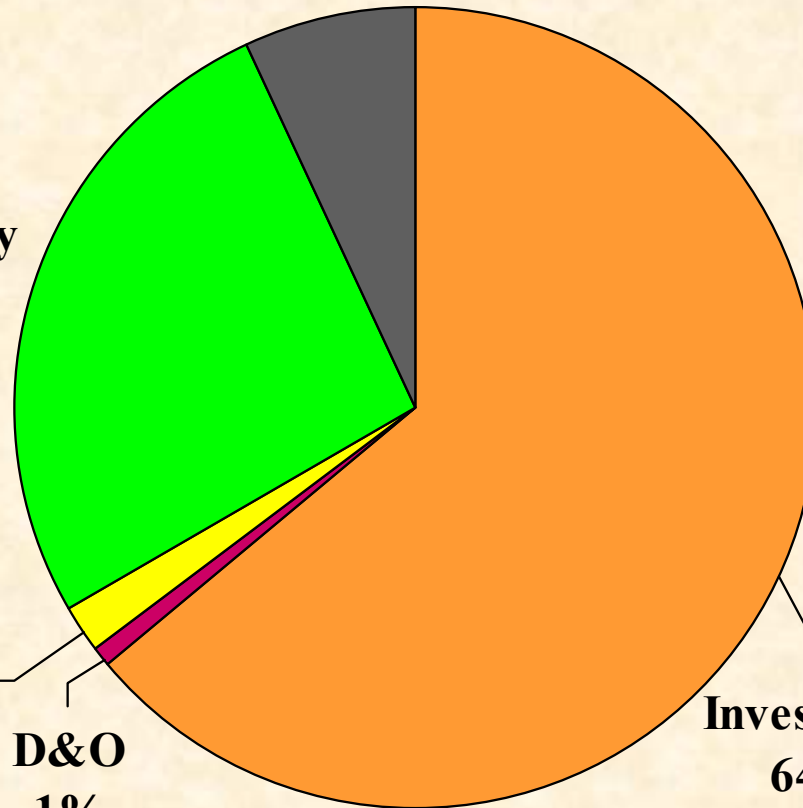
## We Have a Problem

**Total Exposure (Life & Non-Life): \$3.796 Billion**

Multiple  
7%

- Enron is the biggest bankruptcy in US history (\$31B+)
- Equity/debt widely-held as S&P 500 company
- Biggest impact in institutional investors/creditors
- 11 Congressional investigations
- 56 suits against officers & directors
- Will spark similar suits

Surety  
26%



Fin. Guarantee  
2%

D&O  
1%

Investment  
64%

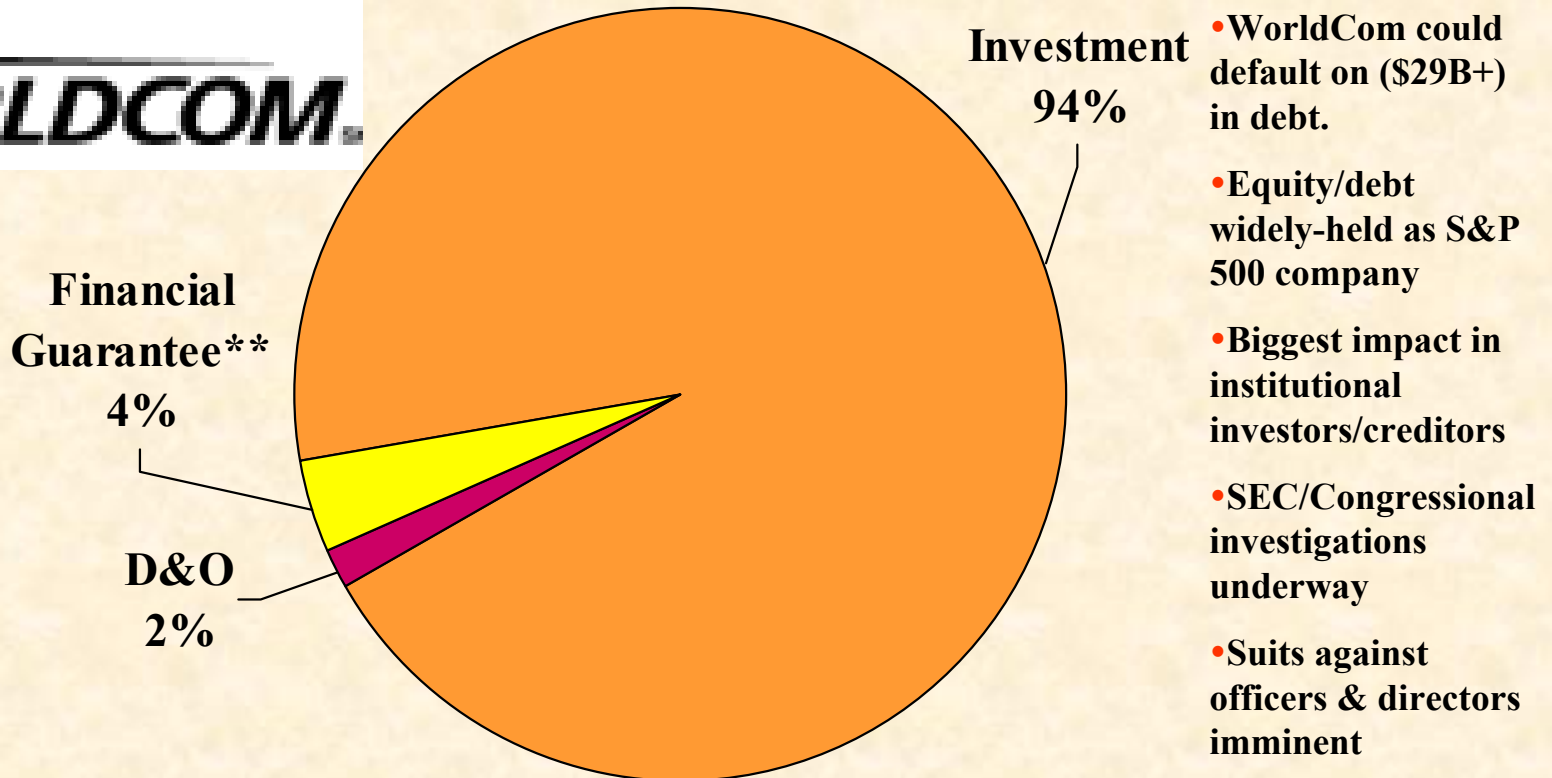




# WorldCom to WorldCon?

## Insurer Exposure

**Total Exposure (Life & Non-Life): \$5.725 Billion\***

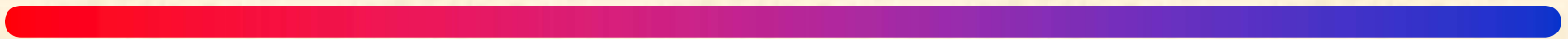


\*As of 7/1/02; Includes \$5.4B in debt assuming default, \$100 mil D&O, \$225 mil CDO (still collateralized). As of 7/1, WCOM debt trading at about \$0.15 of par, stock trading at \$0.08/share. Equity losses are indeterminant.

\*\*Does not include disclosed but unquantified exposure to credit default swaps




Source: Insurance Information Institute based in from Moody's, company announcements, III research.

*Who's Who in the  
Corporate House of Ill-Repute*










# Corporate Hall of Shame

Company	Problem	Potential Charges
	D&Os created complex outside partnerships that kept billions in losses of Enron's balance sheet; Accused by CA of manipulating energy market	<ul style="list-style-type: none"><li>• Securities Fraud</li><li>• Insider trading</li><li>• Perjury</li></ul>
	Lax oversight of some client books, conflicts of interest, shredded documents	<ul style="list-style-type: none"><li>• Guilty of obstruction of justice</li><li>• Individual partners may be liable</li></ul>
	Inappropriately accounted for \$3.8B in expenses, inflated profits	<ul style="list-style-type: none"><li>• Fraud</li></ul>






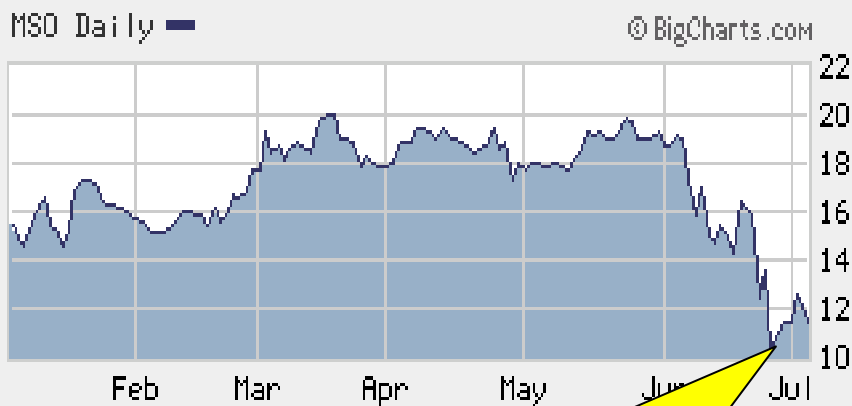
# Corporate Hall of Shame

Company	Problem	Potential Charges
	Ex-CEO Dennis Kozlowski indicted for tax evasion on art purchases	<ul style="list-style-type: none"><li>• Tax evasion</li><li>• Misuse of corporate funds</li><li>• SEC accounting query</li></ul>
	Bogus capacity swaps inflated revenues (Qwest did too); Dynegy = “round-tripping” to inflate revenue	<ul style="list-style-type: none"><li>• Securities fraud</li><li>• Insider trading</li></ul>
 <b>ImClone Systems Incorporated</b>	Ex-CEO Sam Waksal indicted June 12 for tipping off family & <u>friends</u> that FDA did not approval of cancer drug Erbitux	<ul style="list-style-type: none"><li>• Insider Trading</li></ul>  



# Corporate Hall of Shame

Company	Problem	Potential Charges
	\$4.6B in undisclosed loans to founding Rigas family; Misc. unconventional transactions, questionable accounting	<ul style="list-style-type: none"><li>• Securities fraud</li><li>• Misuse of corporate funds</li><li>• SEC accounting query</li></ul>
	Questionable acctg. in sales of fiber optic capacity; Ex-CEO Nacchio under fire for excessive compensation & questionable stock sales	<ul style="list-style-type: none"><li>• Fraud</li><li>• Possible insider trading</li></ul>
	Complex projects exaggerated cash flow; “Round-tripping” to inflate revenue	<ul style="list-style-type: none"><li>• Possible fraud</li></ul>



**Martha Stewart Omnimedia fell by more than 50% after Imclone insider trading scandal broke out**



**This sumptuous New England lobsterbake is available at MarthaStewart.com for just \$250!**

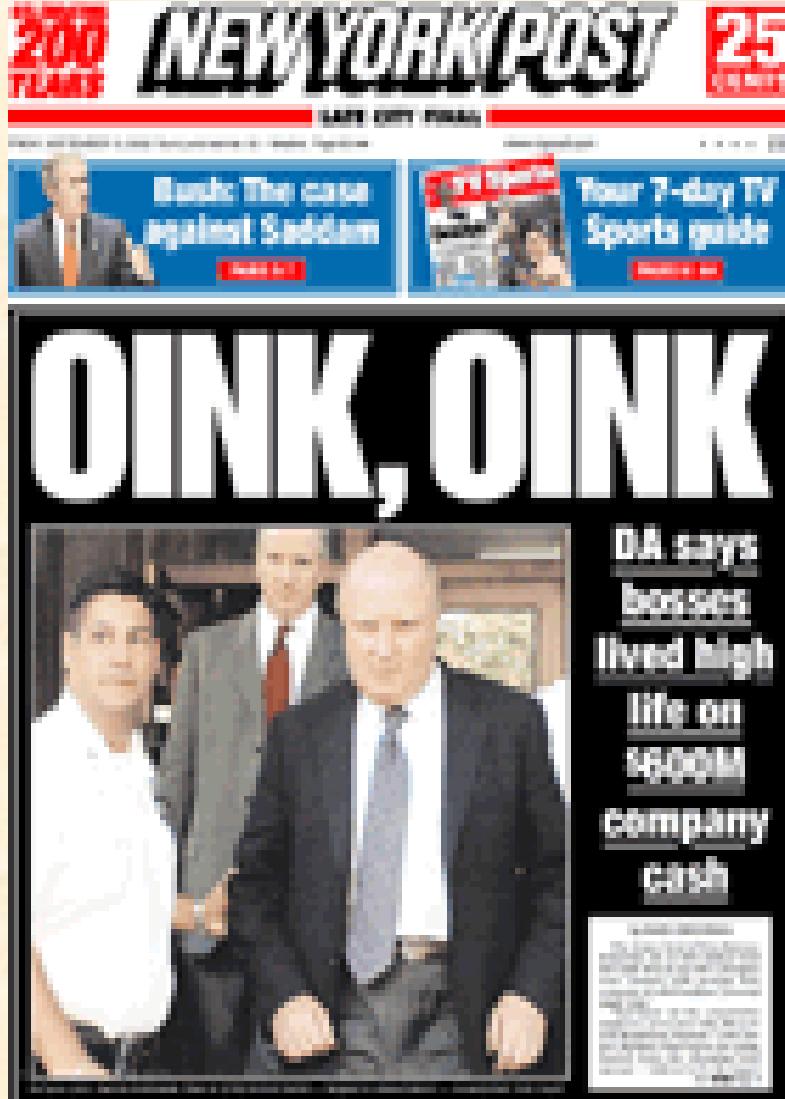




# *Cynicism is Running High*



# *Living High Off the Company Hog*

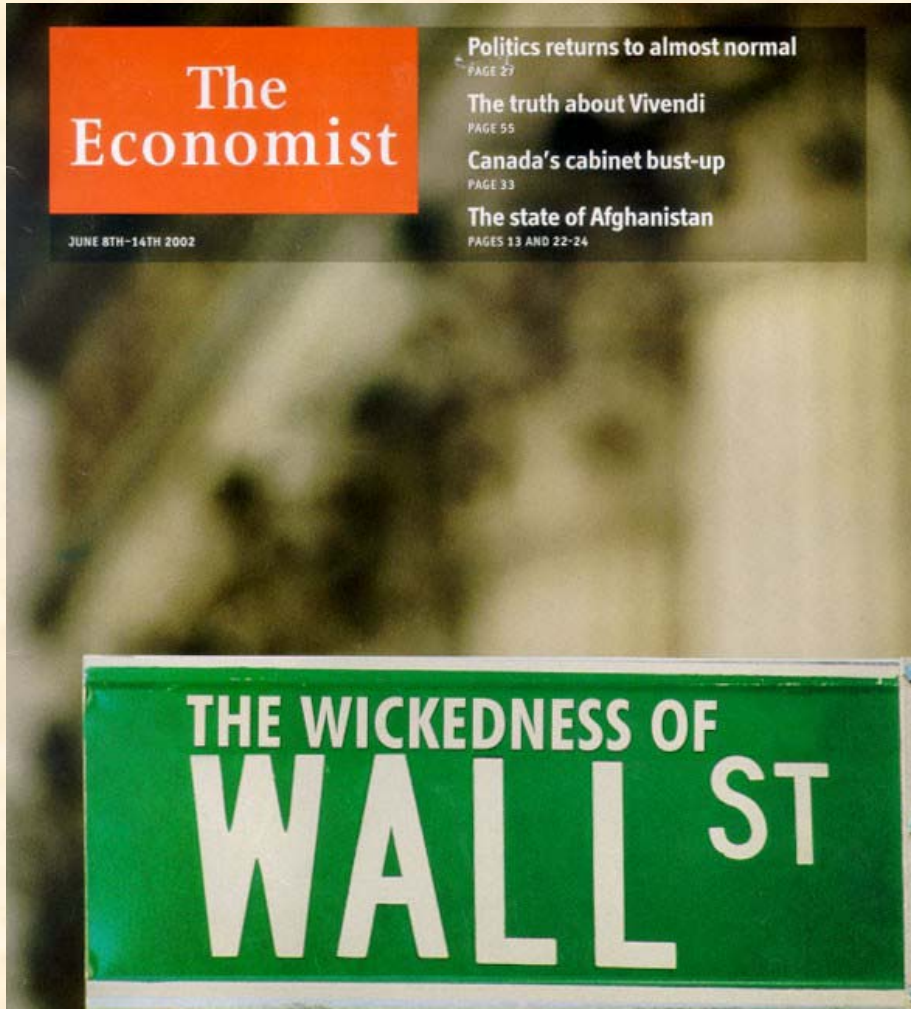


**Bernie Ebbers, former CEO  
of WorldCom**

**Dennis Kozlowski, former  
Tyco CEO**



# Wall Street Conflicts of Interest Breed a Crisis of Confidence





# *Investment Risk*



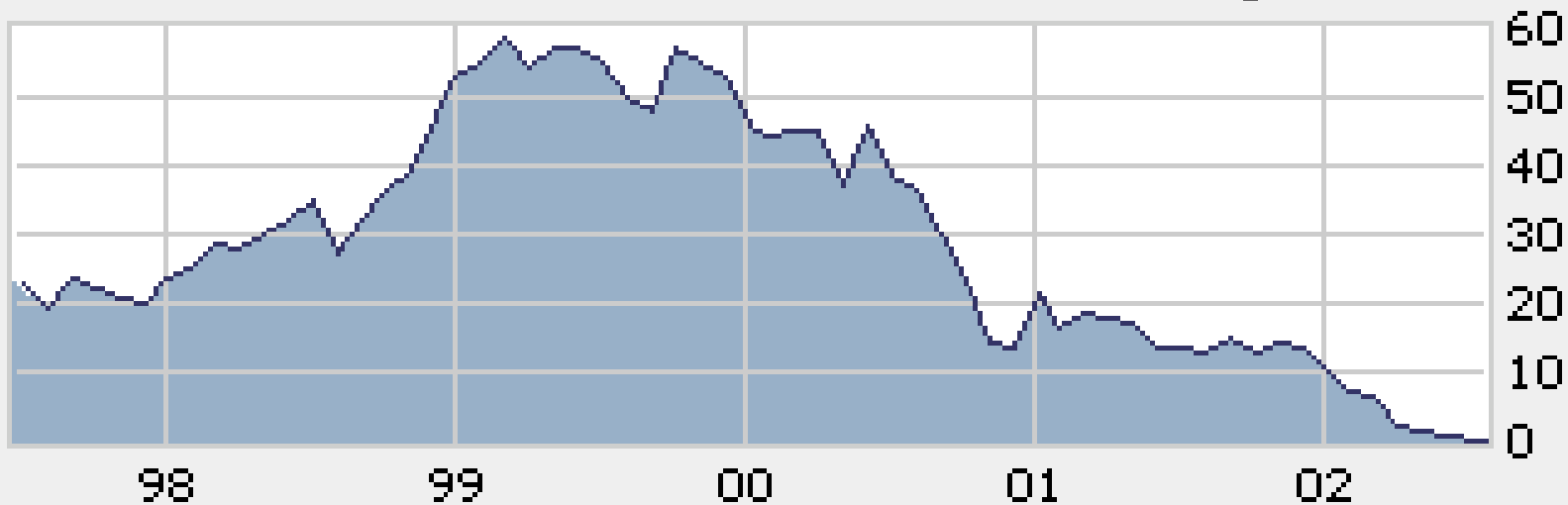


# *WorldCom: From \$60/share in to 6 Cents in Three Years*

**As of July 1, 2002**

WCOM Monthly —

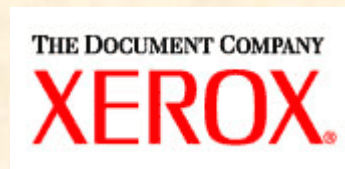
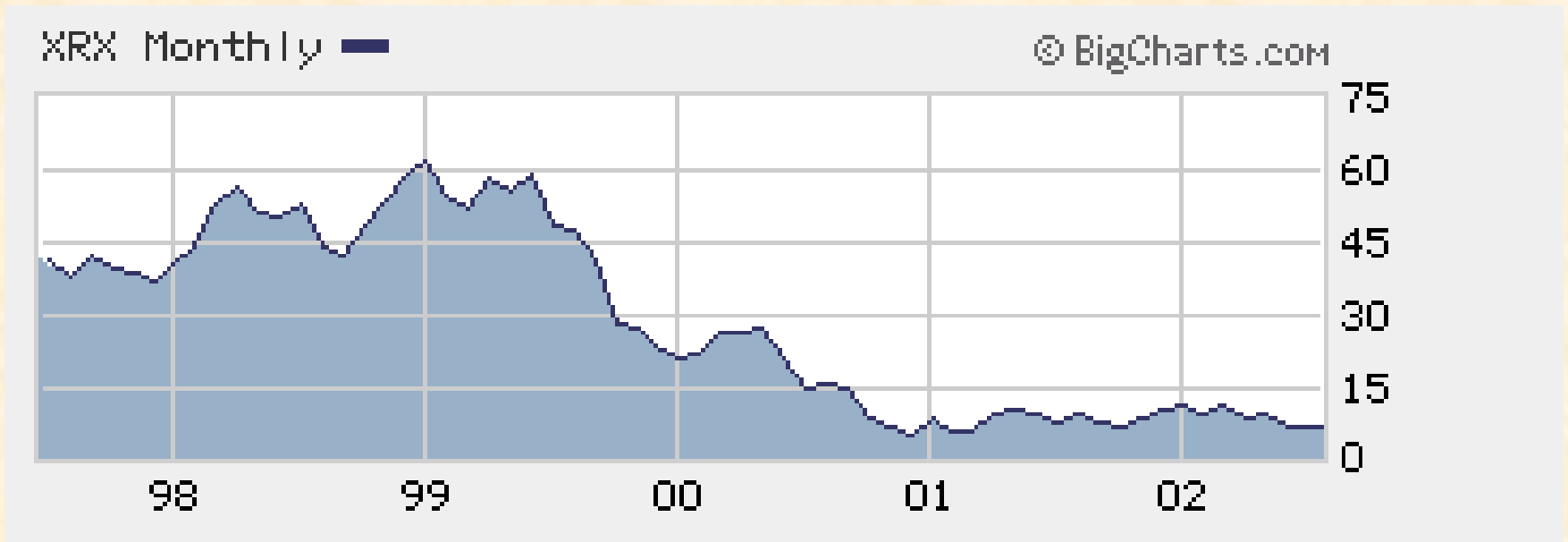
© BigCharts.com





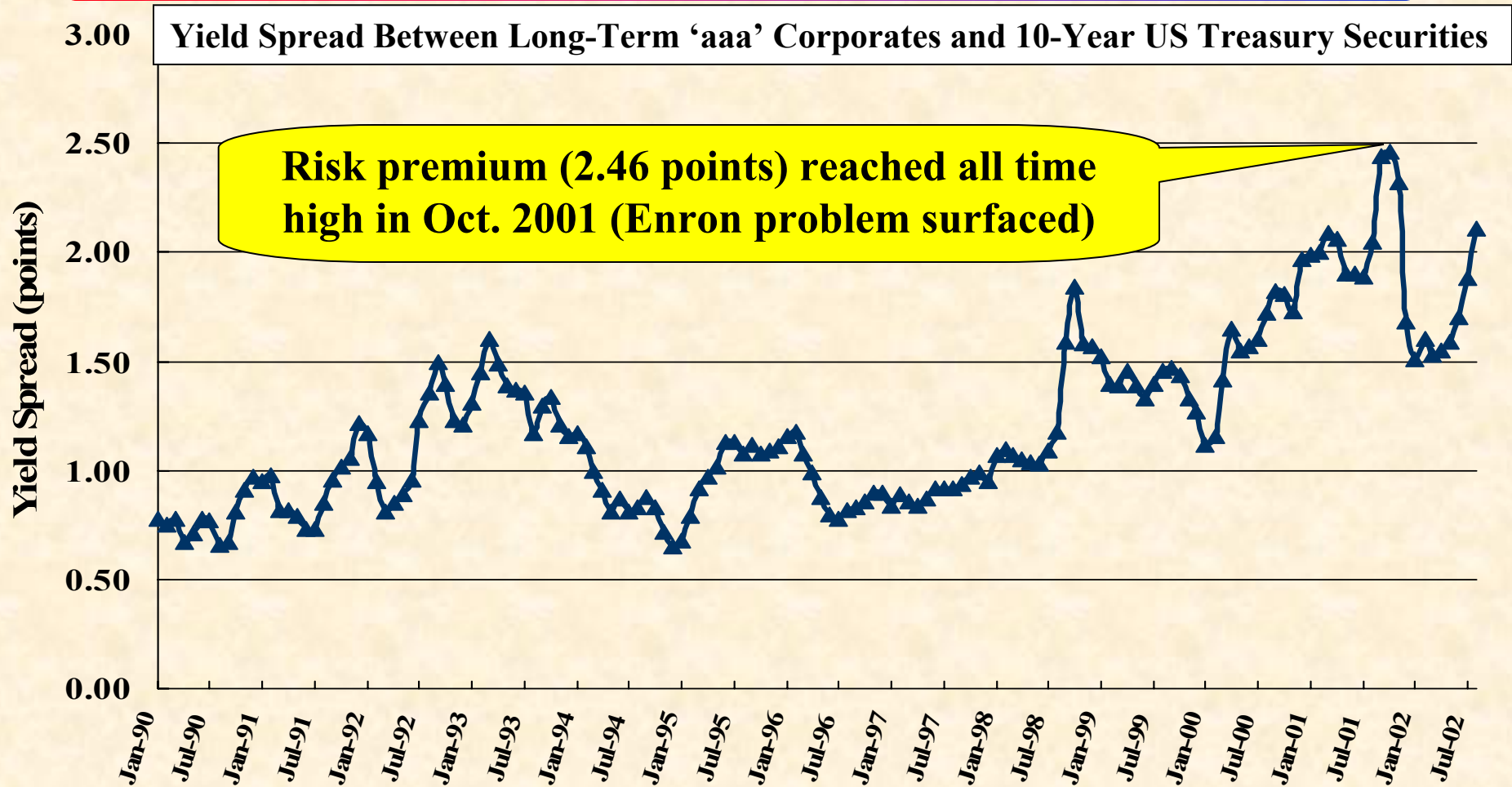
# *Xerox: From \$60/share in to \$6.60 Cents in Three Years\**

**As of July 1, 2002**





# *Risky Business: Yield Spread* *Rising with Corporate Scandals\**

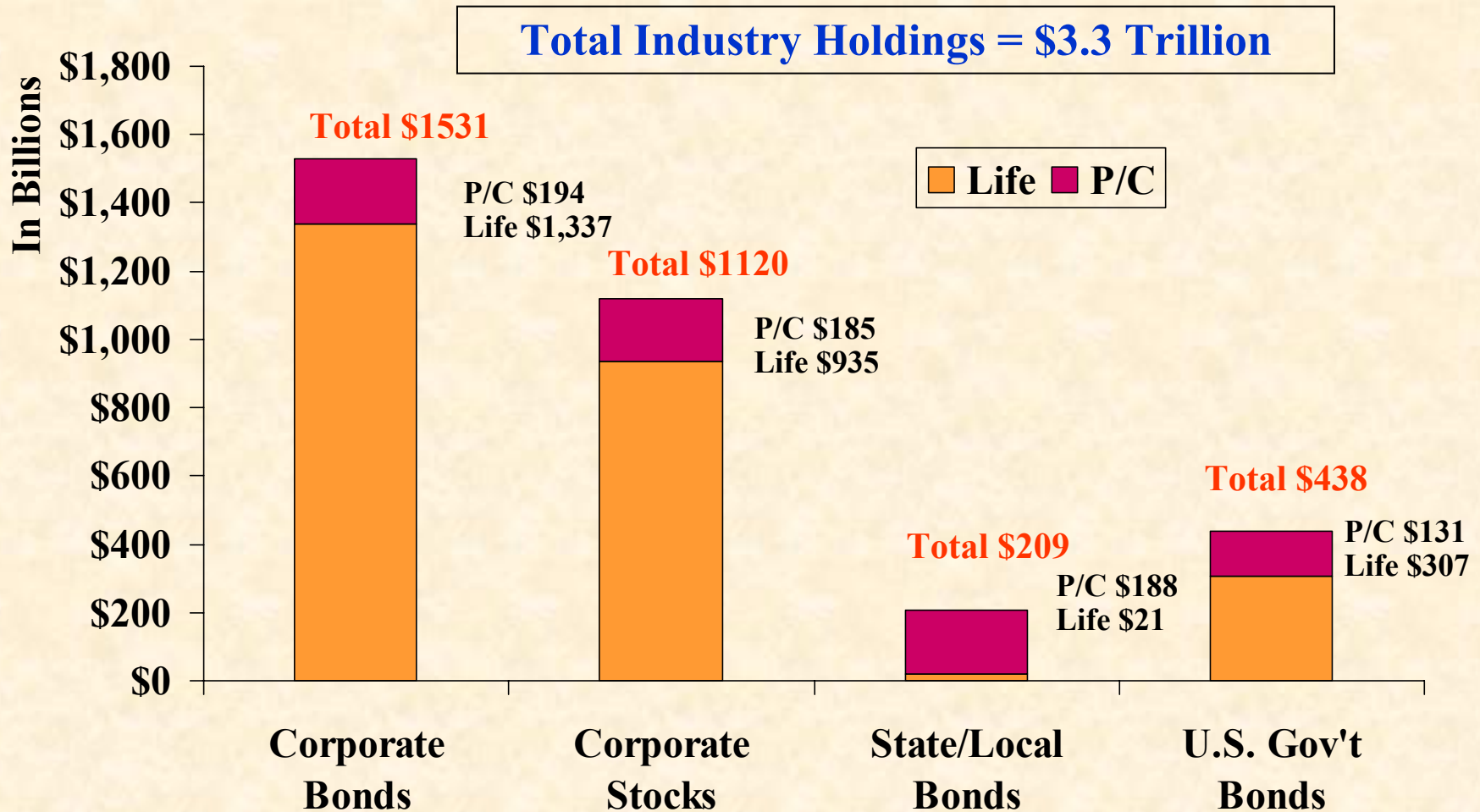


\*January 1990 through August 2002

Source: Board of Governors, Federal Reserve System; Insurance Information Institute



# Insurance Industry Stock and Bond Holdings, 2001





# *Institutional Investor Market in Corporate Equities*

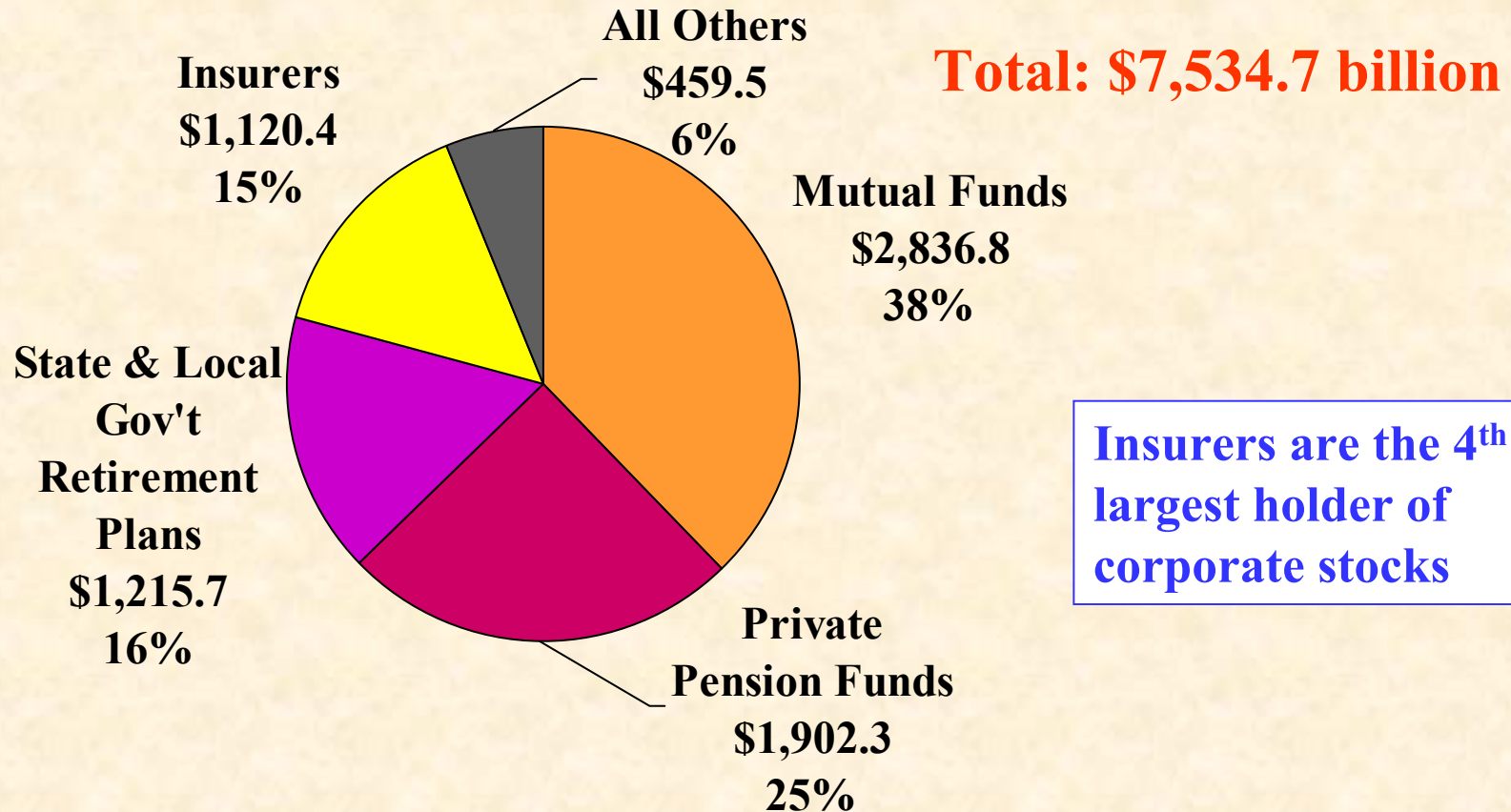
by Market Value of Holdings, as of December 31, 2001





# *Institutional Investor Market in Corporate Equities*

by Amounts Outstanding, as of December 31, 2001

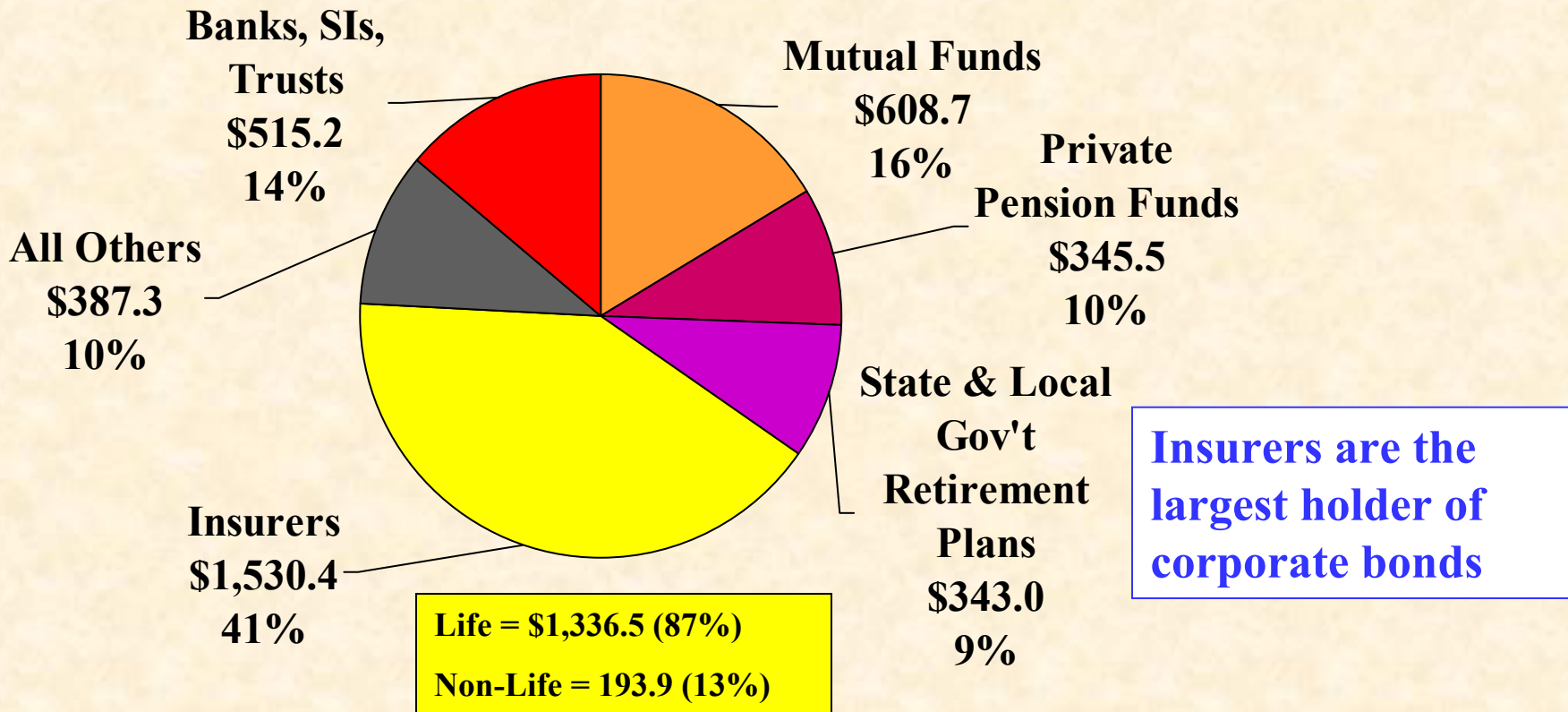




# *Institutional Investor Market in Corporate Bonds\**

**By Amounts Outstanding, as of December 31, 2001**

**Total: \$3,730.1 billion**

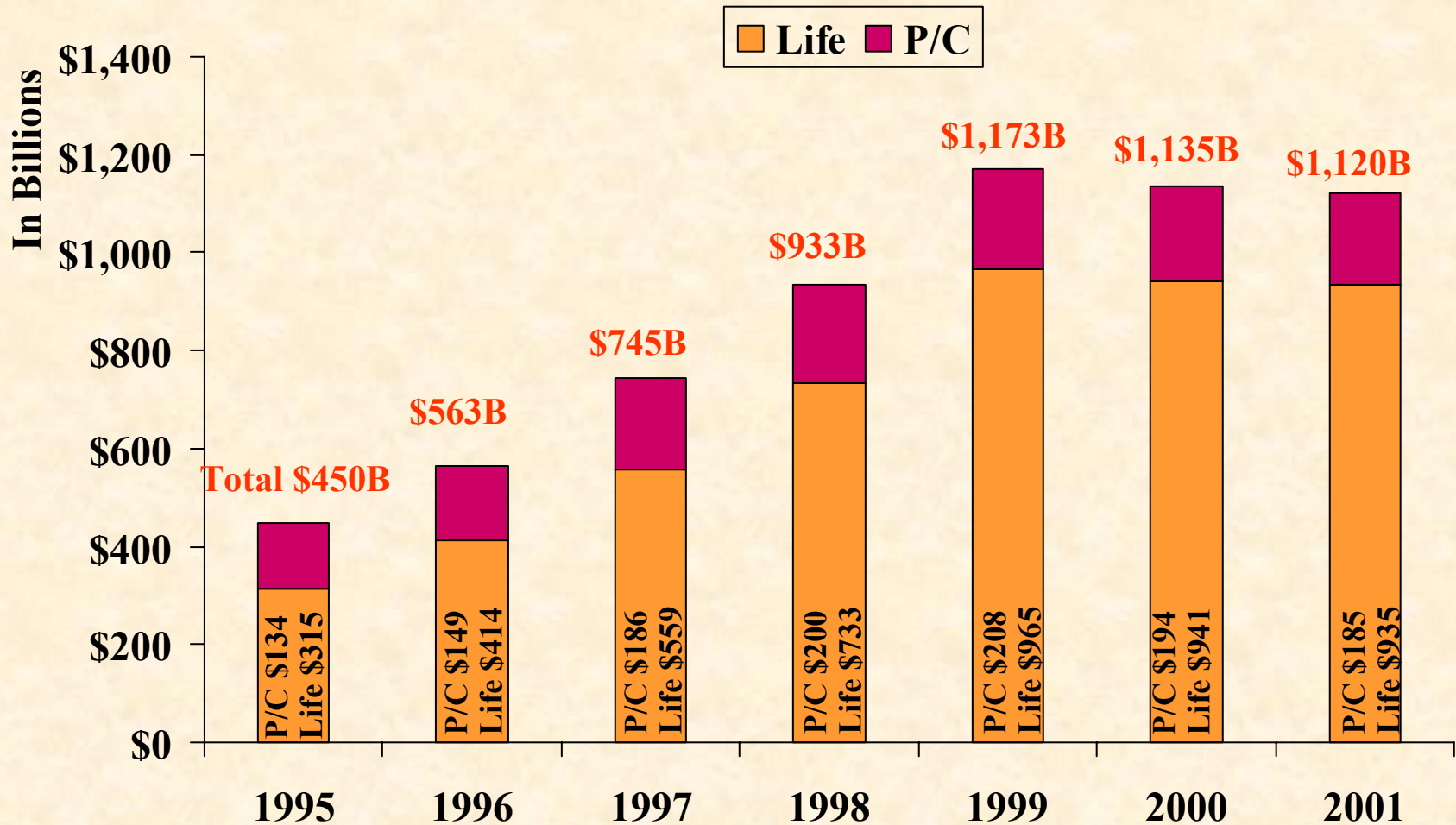


\*Includes foreign bonds.

Source: Insurance Information Institute from Federal Reserve Flow of Funds Report



# *Insurance Industry: Corporate Equity Holdings, 1995-2001*





# *Insurance Industry: Corporate Bonds Holdings, 1995-2001*

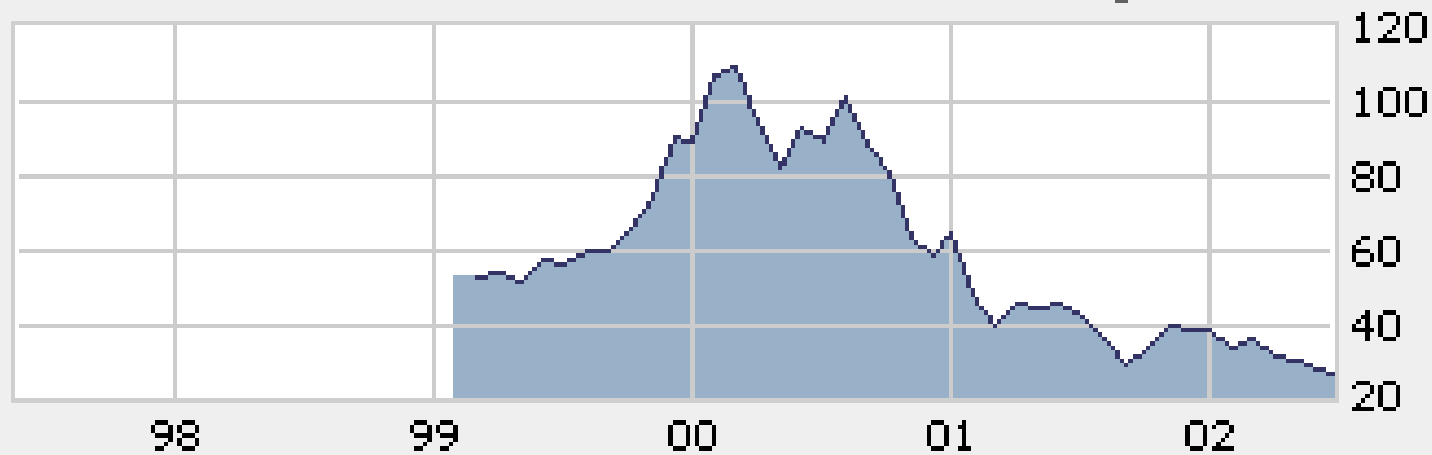




# *Beginning of the End: Bursting of the Tech Bubble*

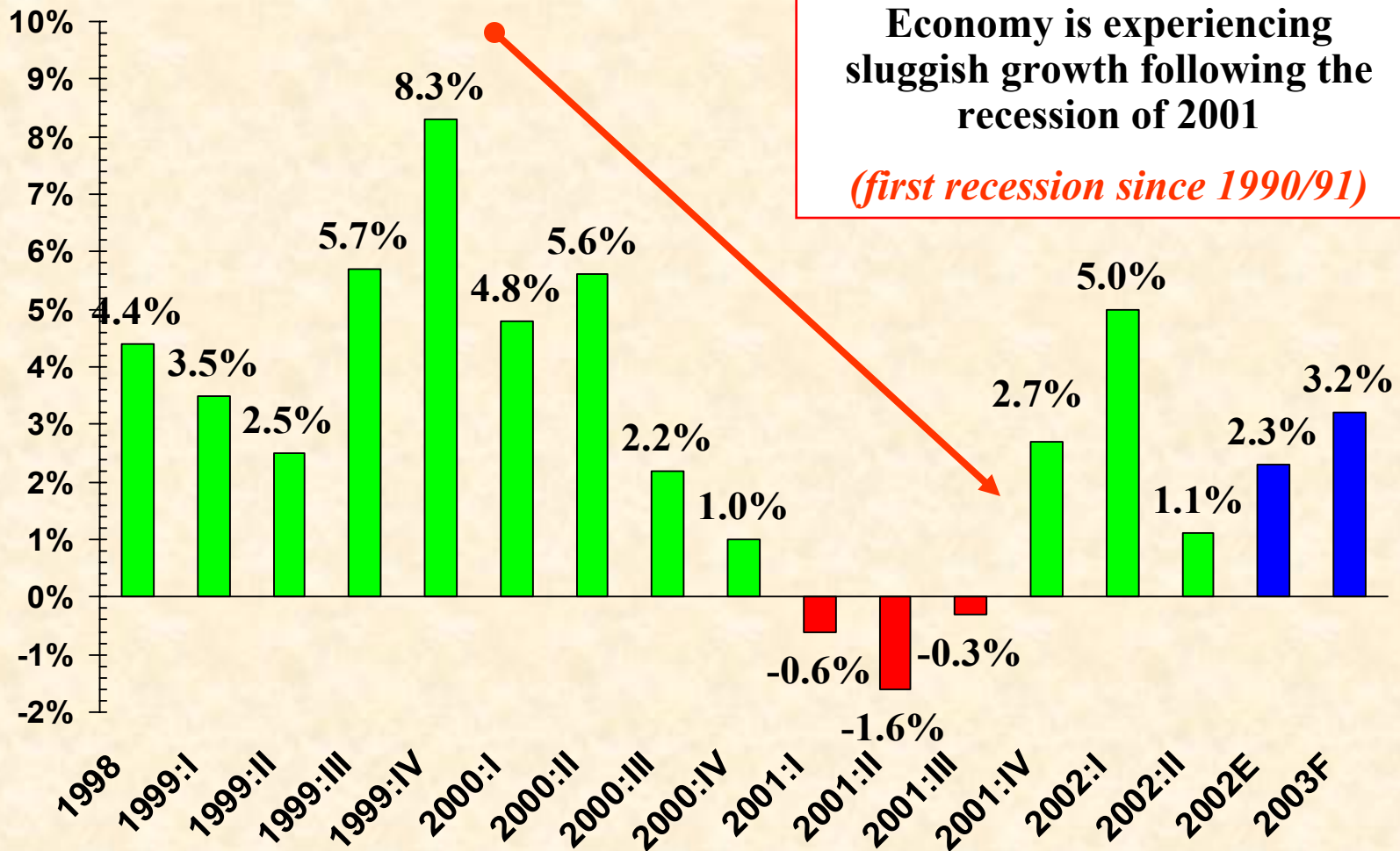
QQQ Monthly

© BigCharts.com

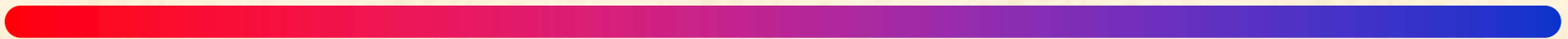




# Real GDP Growth



# *Directors & Officers Coverage*





# *The ABC's of D&O*

## **3 Components of D&O Coverage**

- A. **Personal Coverage**: protects directors and officers against liability arising out of “wrongful acts”
- B. **Corporate Reimbursement Coverage**: reimburses organization when legally required/permitted to indemnify D&Os for their “wrongful acts”
- C. **Entity Coverage**: reimburses for claims made directly against the organization (including those that name no individual insureds)
  - **Today, about 90% have entity coverage today, compared to 30% 5 years ago.**



# *The ABC's of D&O*

## **Duties of Directors & Officers**

### 1. **Duty of Care:**

- D&Os must exercise “reasonable care”
- Courts hold that D&Os are not guarantors of profitability
- Directors not required to have special knowledge of business

### 2. **Duty of Loyalty to Corporation:**

- Undivided loyalty required (should be no conflicts-of-interest)

### 3. **Duty of Loyalty to Shareholder:**

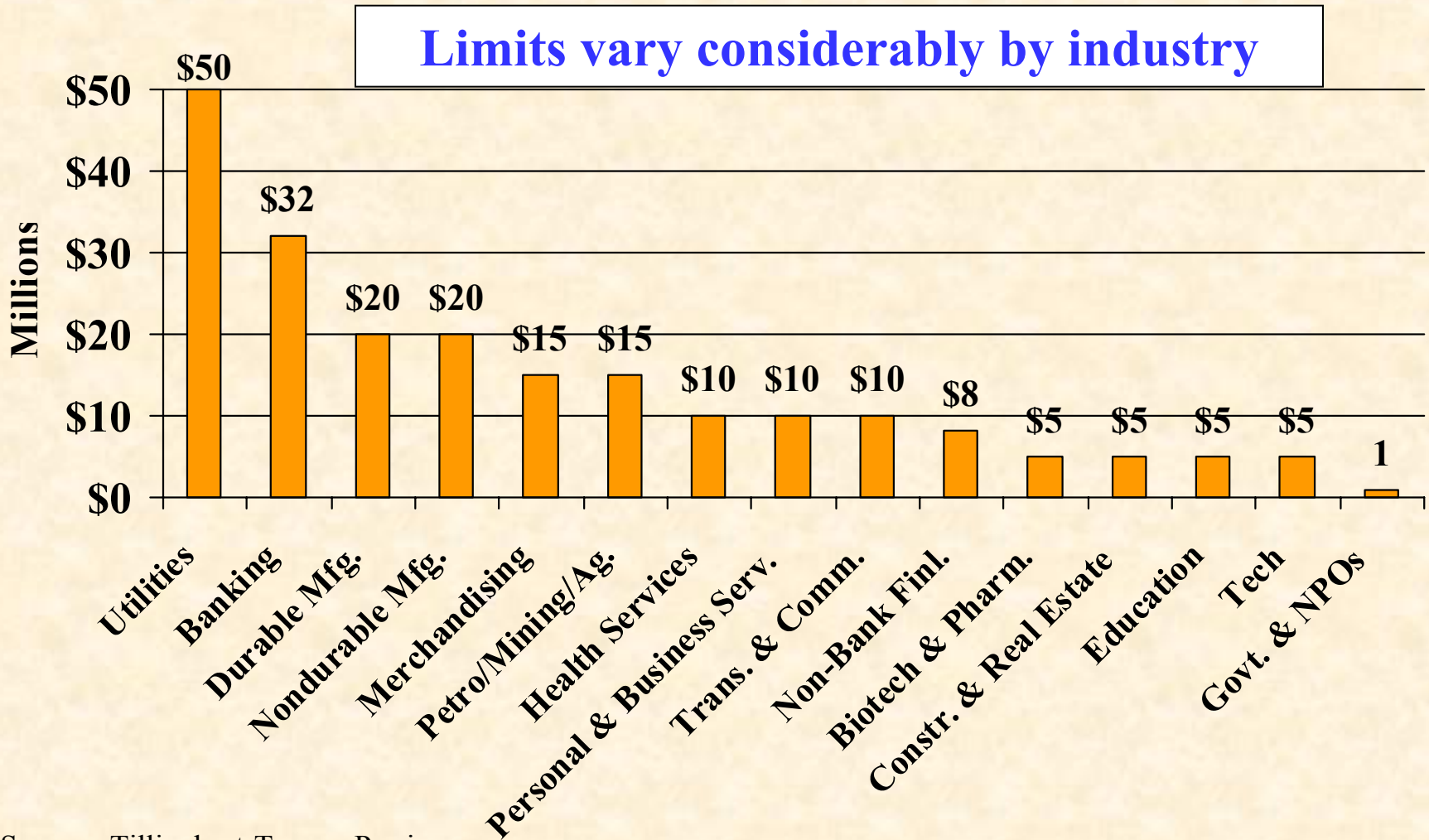
- Prohibits insider trading, for example

### 4. **Duty of Disclosure:**

- Officers must disclosure material facts to directors
- Officers must disclosure material facts to regulators
- Officers must disclosure material facts to creditors or potential creditors
- Officers must disclosure material facts to stockholders, bond holders, potential investors

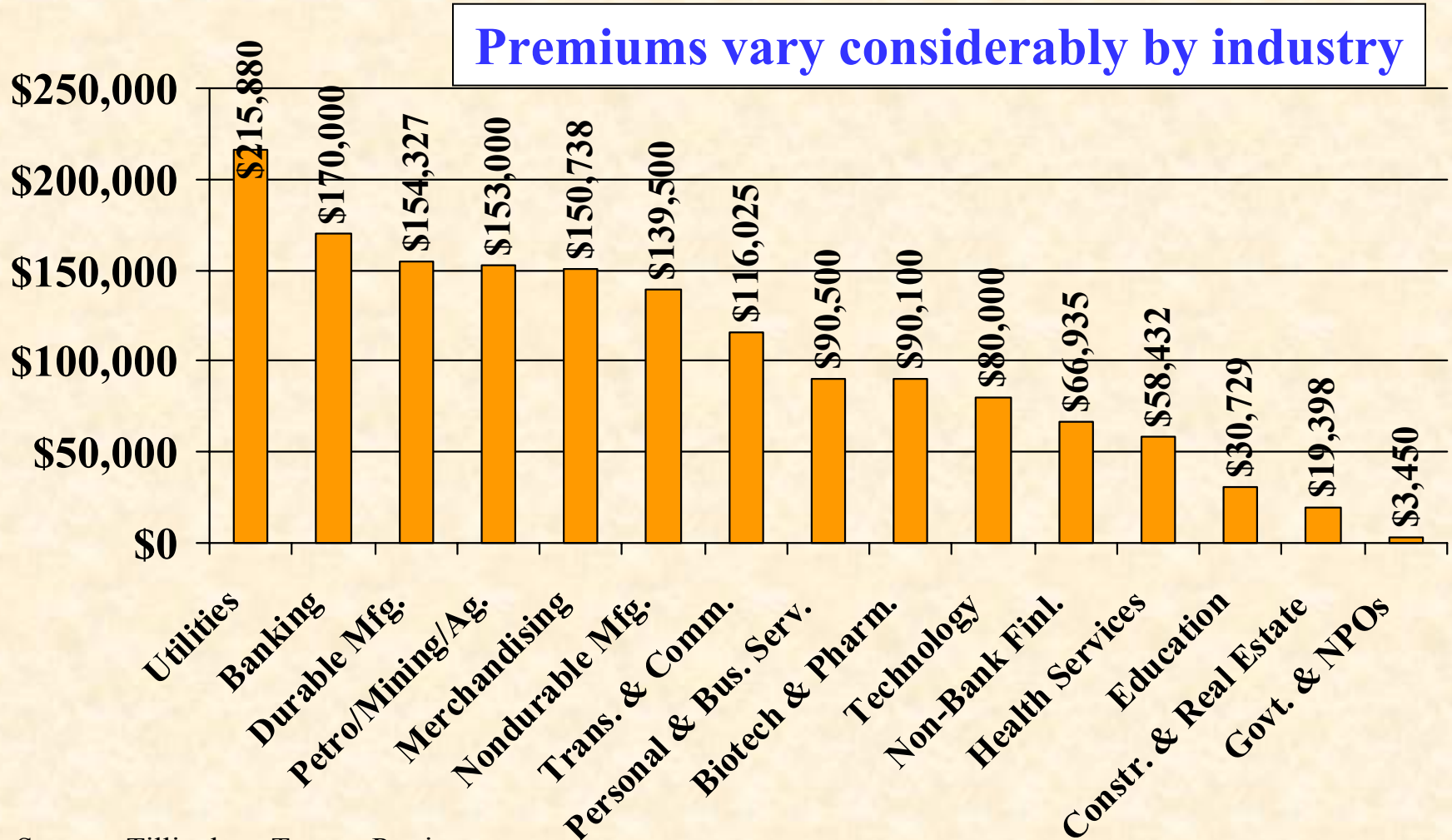


# *Median Total D&O Limits by Business Class (\$ Millions)*





# *Median Total D&O Premium by Business Class*

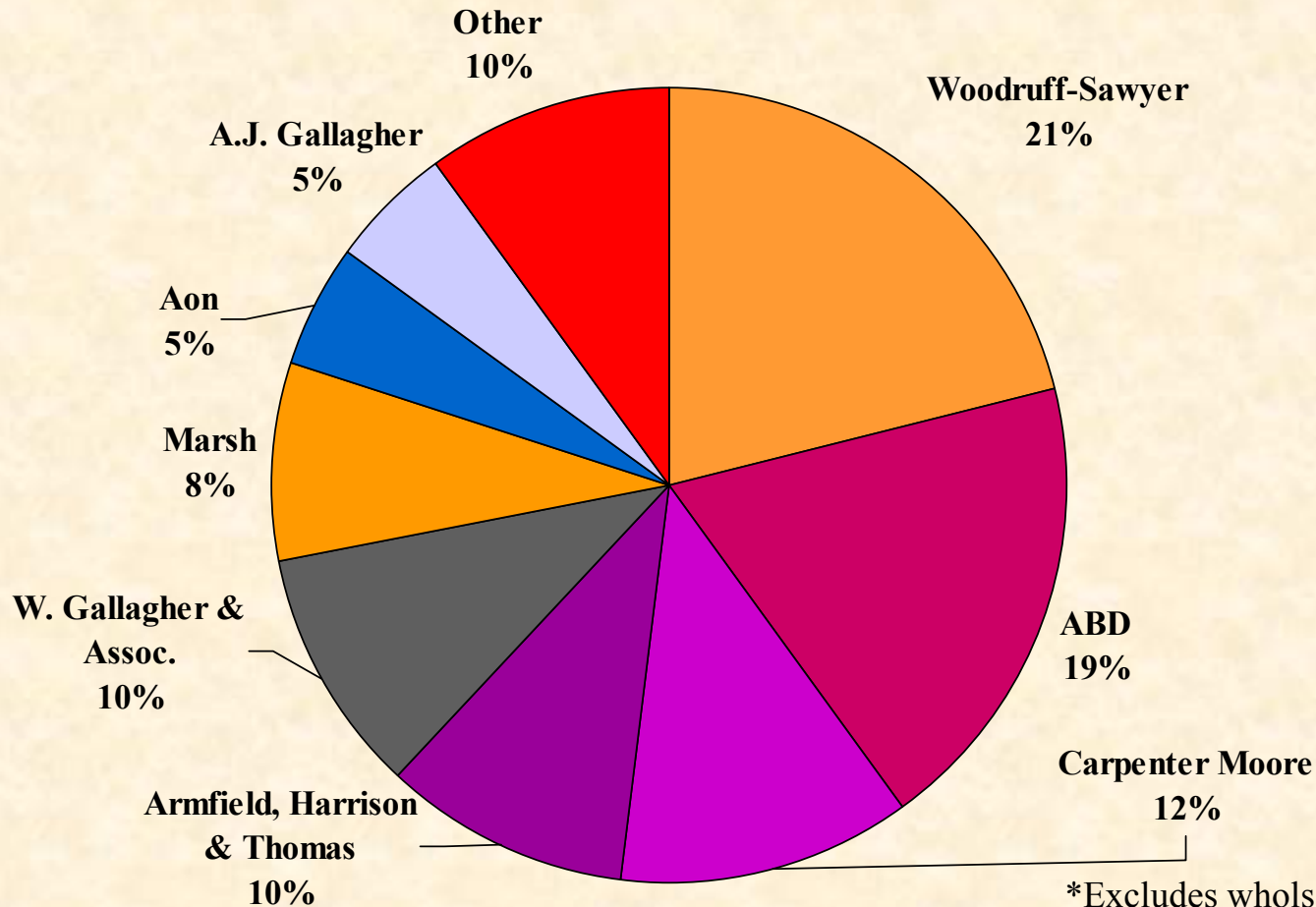


Source: Tillinghast-Towers Perrin



# *D&O Broker Market Share*

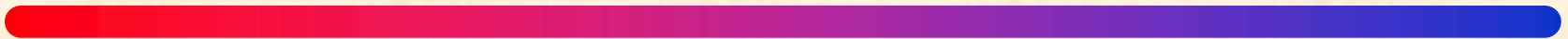
*(by Number of US Retail\* Accts as Primary Broker)*



\*Excludes wholesale brokerage activity;  
Based on sample of 1,976 accounts

# INDUSTRY FINANCIALS

## Overview & Outlook





# *Highlights: Property/Casualty*

## *First-Half 2002 (\$ Millions)*

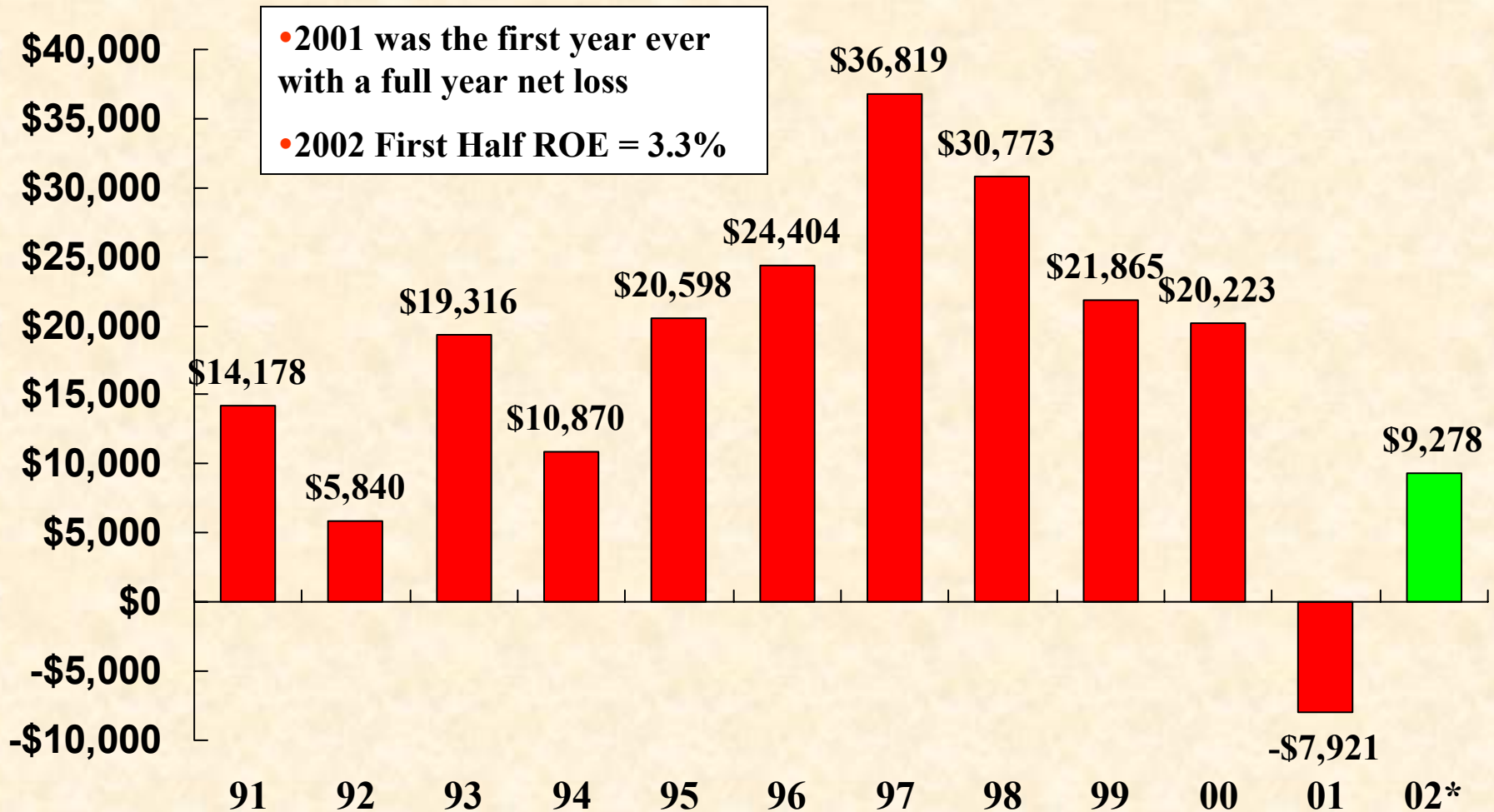
	<b>2002</b>	<b>2001</b>	<b>Change</b>
Net Written Prem.	182,434	162,855	+12.0%
Loss & LAE	134,336	129,301	+3.9%
Net UW Gain (Loss)	(11,285)	(18,781)	-39.9%
Net Inv. Income	17,831	18,749	-4.9%
Net Income (a.t.)	4,639	2,789	+66.3
Surplus*	282,871	289,649	-2.3%
Combined Ratio	105.0	111.1	-6.1 pts.

\*Comparison with year-end 2001;



# *P/C Net Income After Taxes*

## *1991-2002 (\$ Millions)*

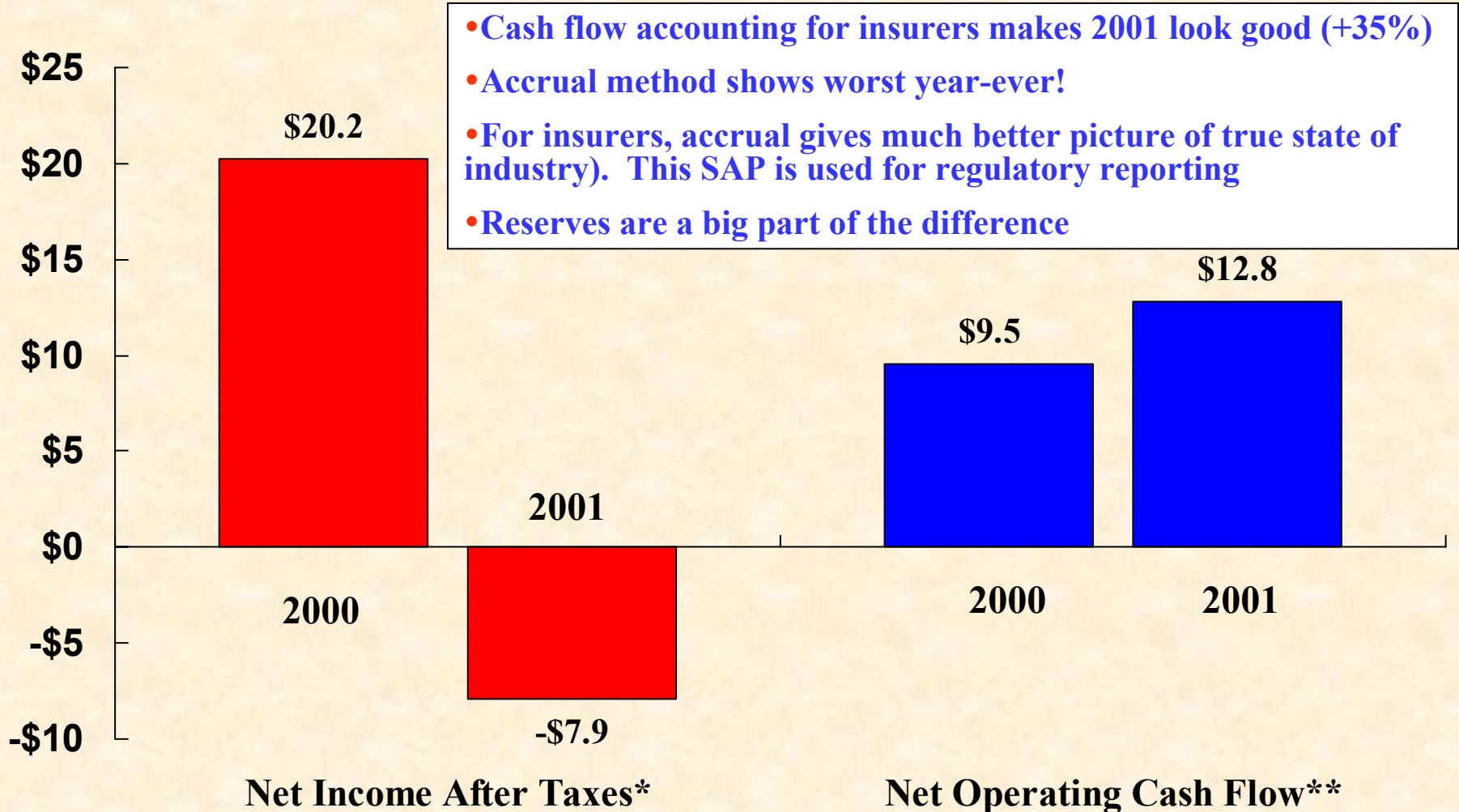


\*I.I.I. estimate based on first half 2002 data.

Sources: A.M. Best, ISO, Insurance Information Institute.



# *P/C Net Income After Taxes vs. Net Operating Cash Flow (\$ Billions)*



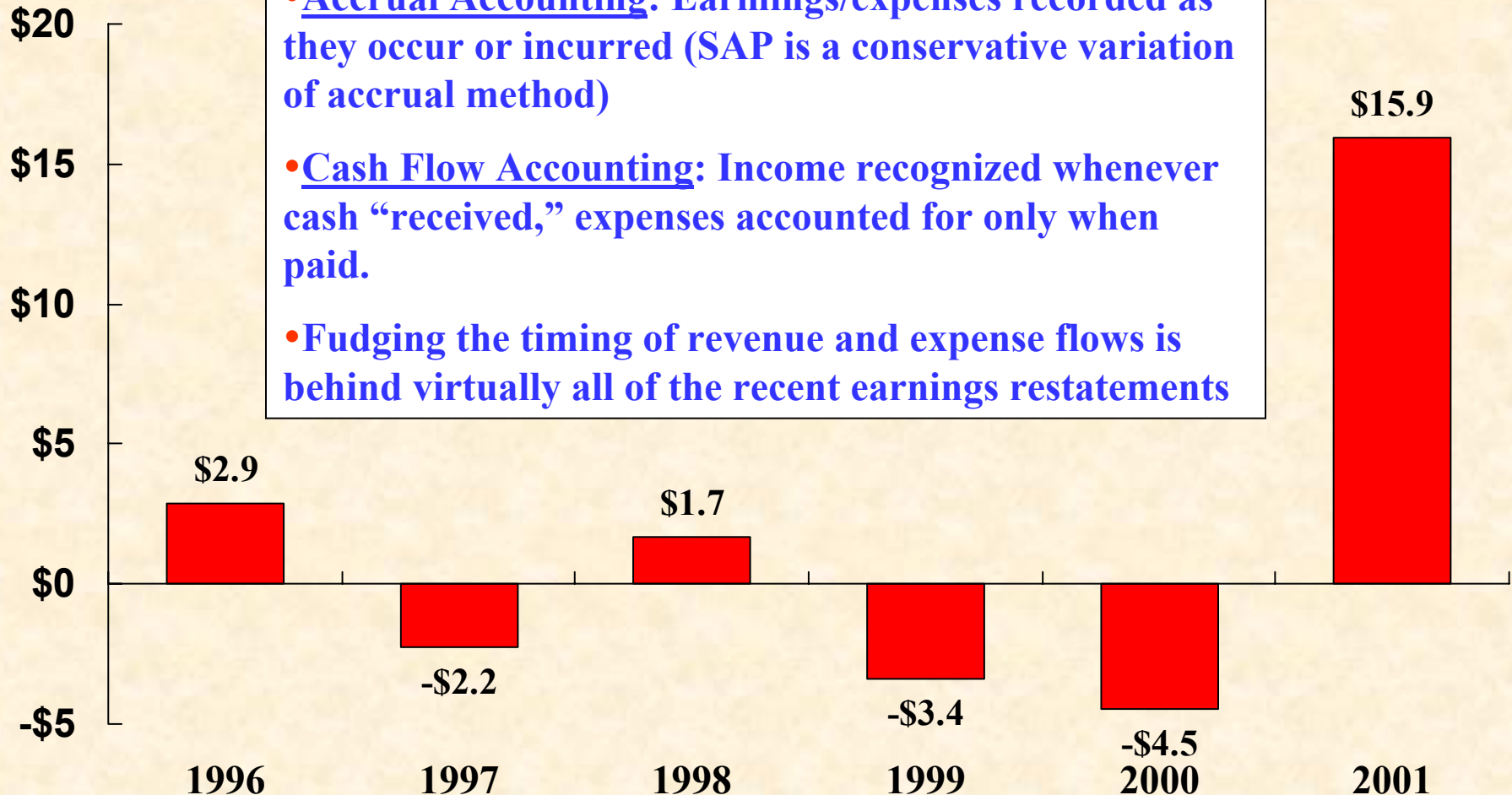
Sources: A.M. Best, Guy  
Carpenter estimates.

\*NIAT = Prem Earned – Exp Incurred + Inv Inc.  
\*\*NOCF = Prem Coll – Exp Exp Pd + Inv Inc.



# Change in P/C Loss Reserves 1996-2001 (\$ Billions)

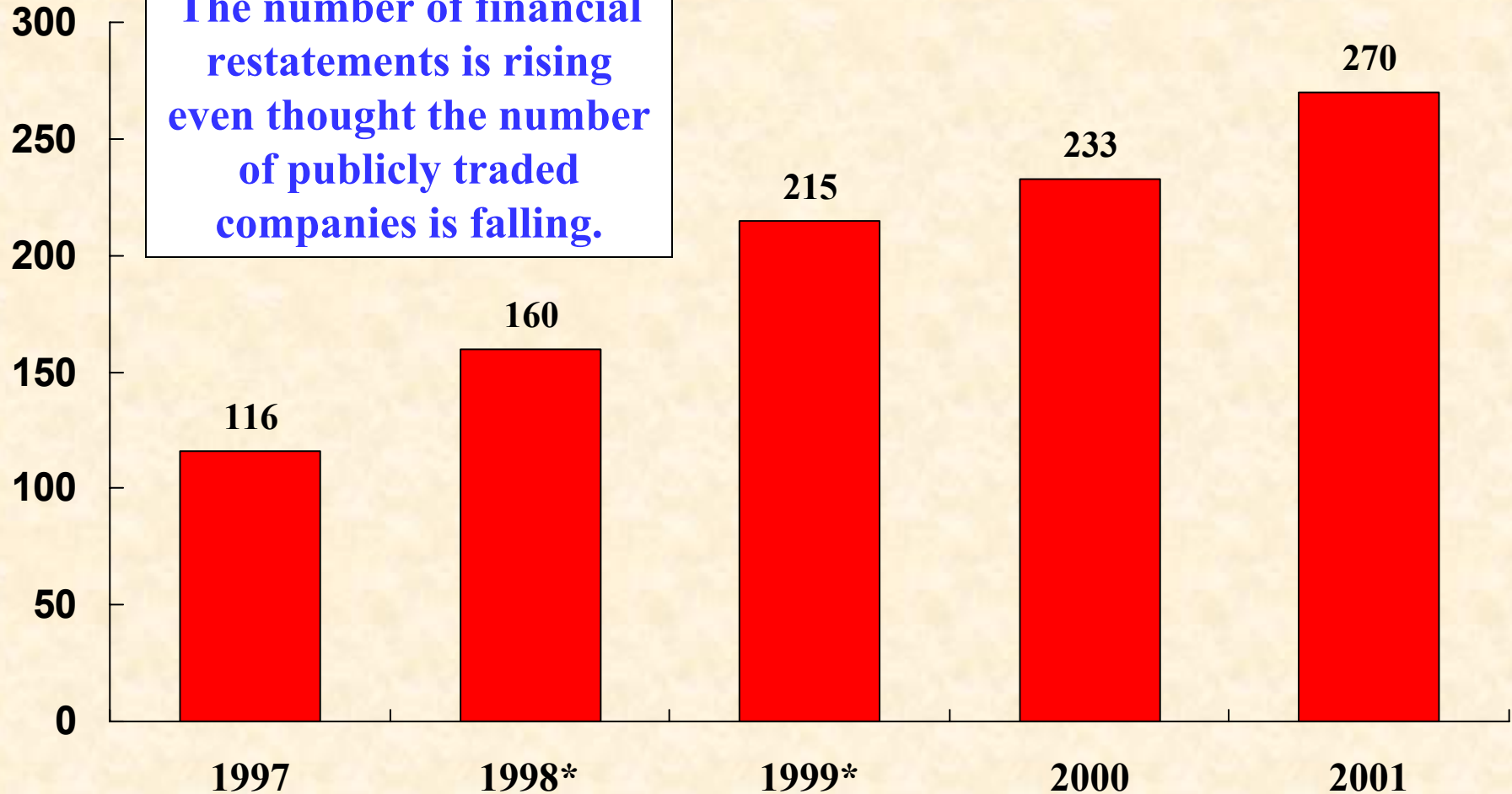
- **Accrual Accounting:** Earnings/expenses recorded as they occur or incurred (SAP is a conservative variation of accrual method)
- **Cash Flow Accounting:** Income recognized whenever cash “received,” expenses accounted for only when paid.
- **Fudging the timing of revenue and expense flows is behind virtually all of the recent earnings restatements**





# *Financial Restatements Filed*

The number of financial restatements is rising even though the number of publicly traded companies is falling.

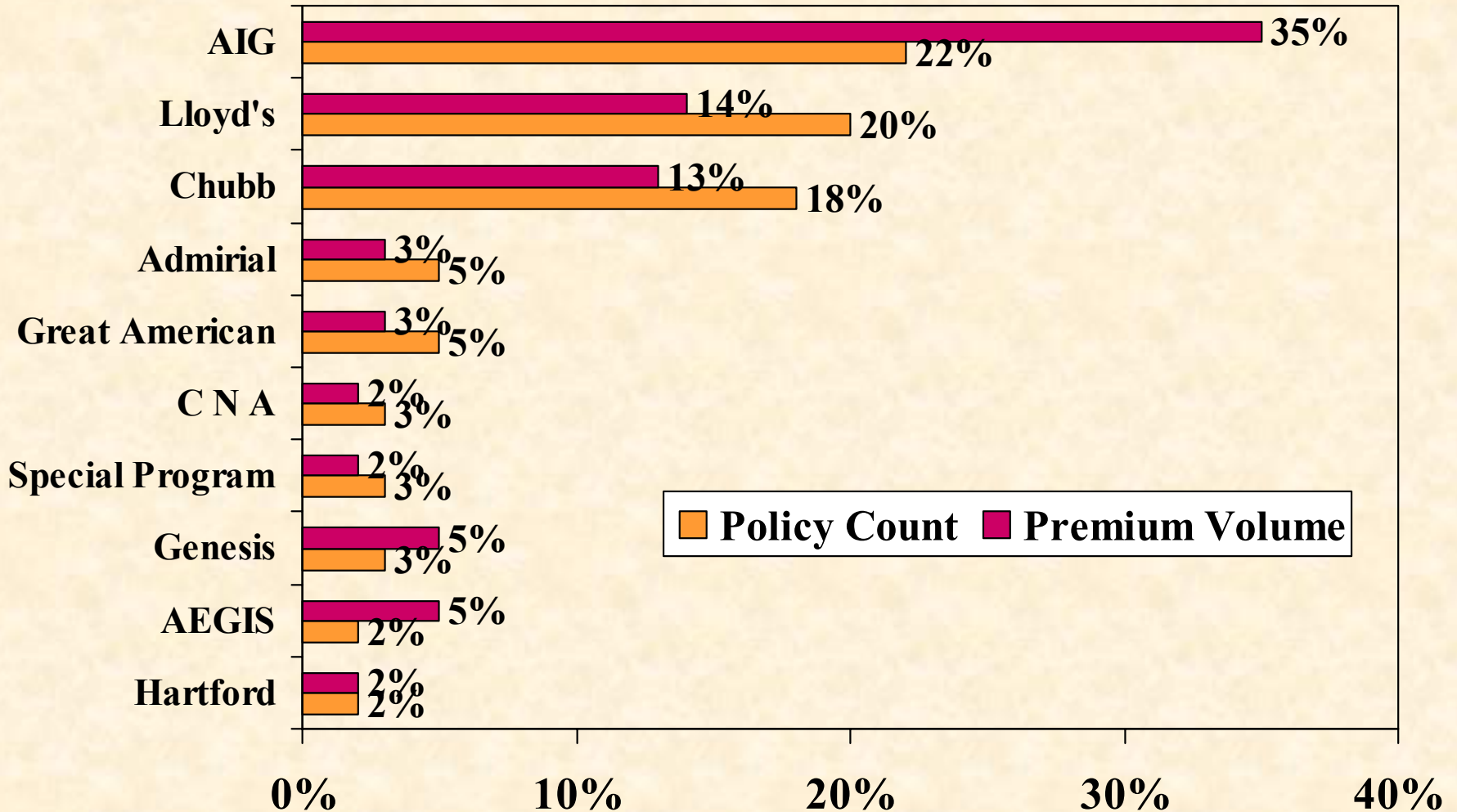


\*Approximate

Sources: Huron Consulting Group



# Market Share for Primary D&O Coverage

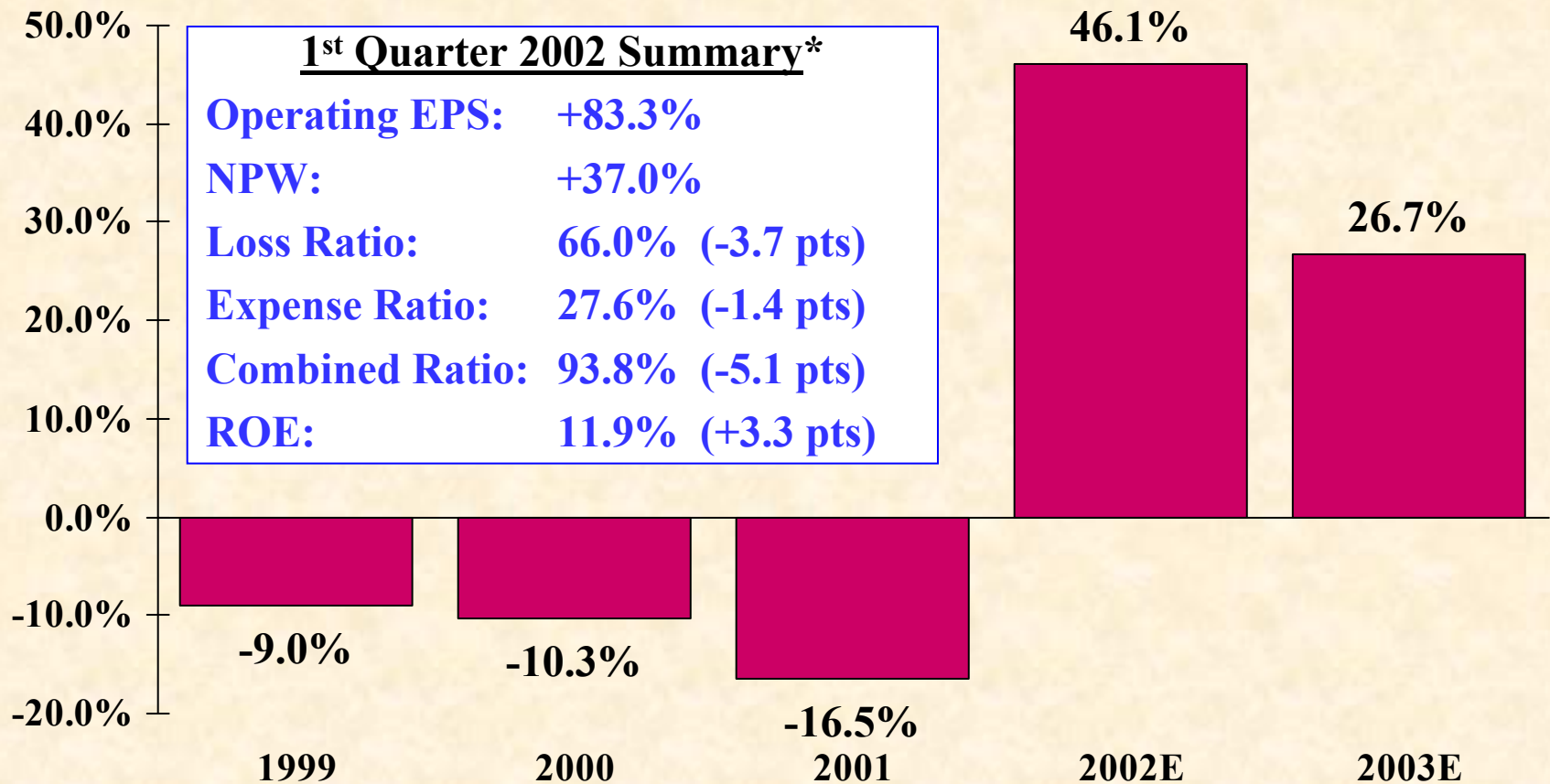


Source: Tillinghast-Towers Perrin



# EPS Growth: Turning the Corner?

## Annual % Increase in Operating Earnings per Share

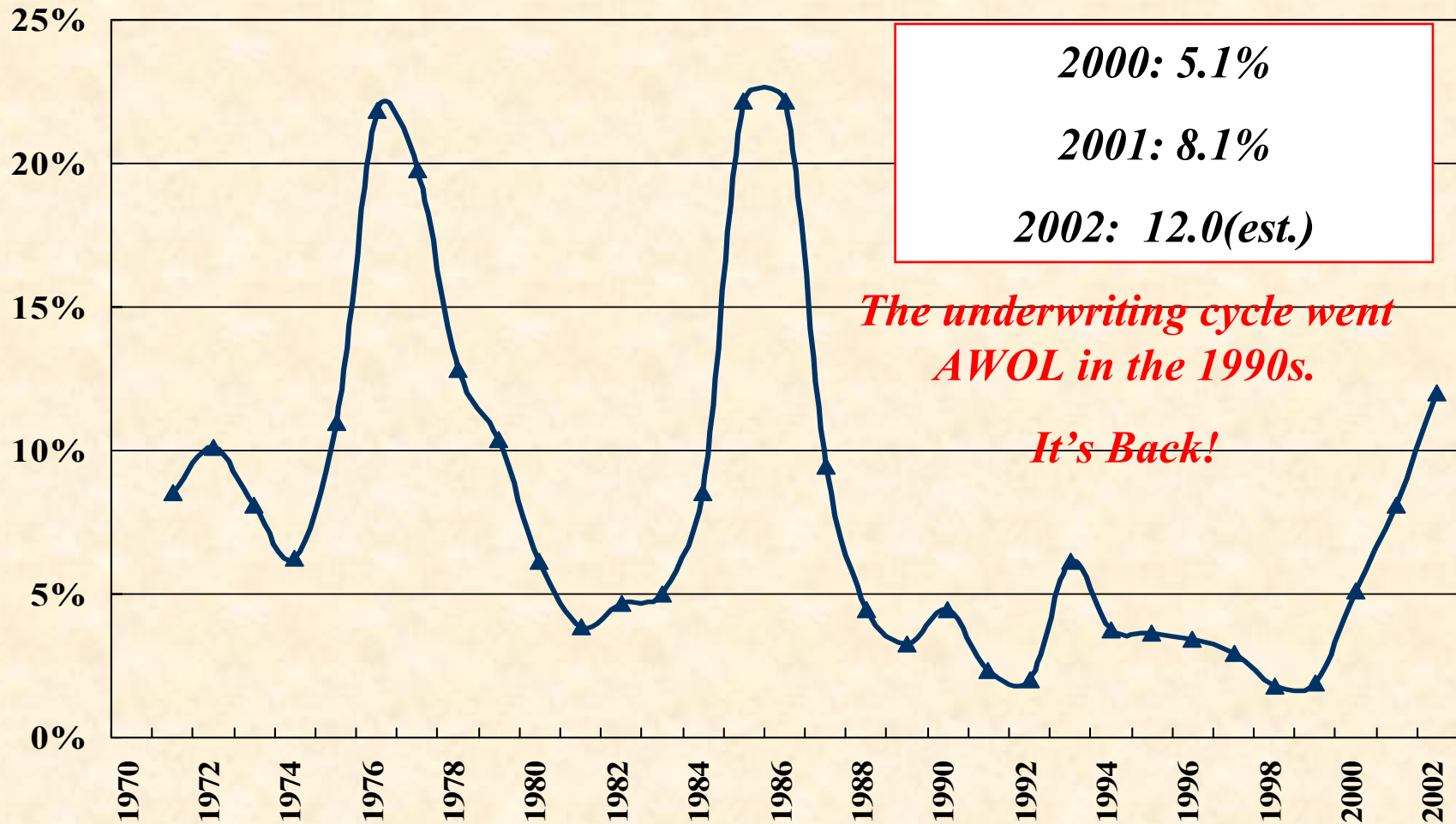


\*Compared to 1<sup>st</sup> quarter 2001.

Source: Company financial statements; Merrill Lynch



# Growth in Net Premiums Written (All P/C Lines)

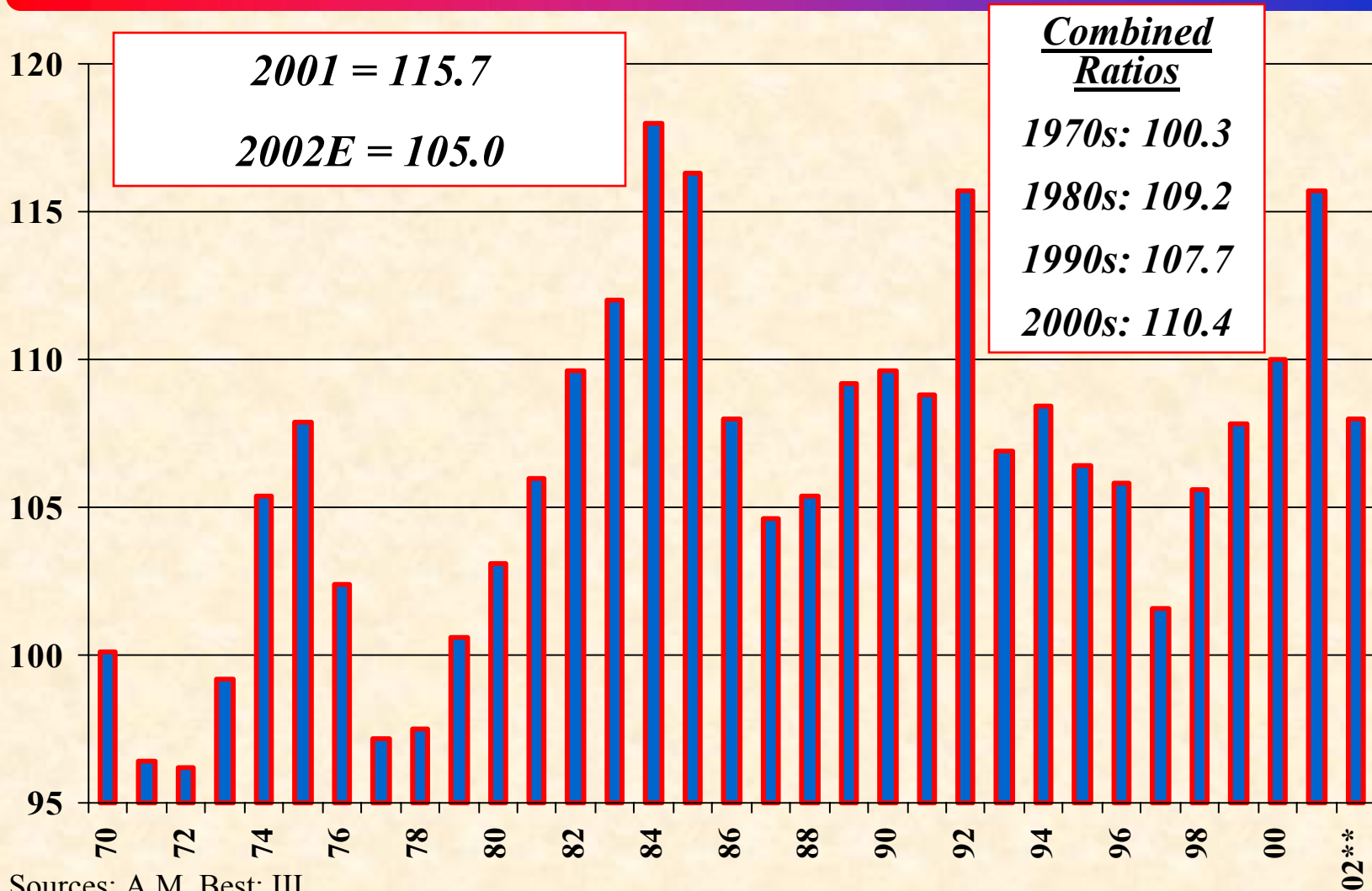


\*Estimate based on first half 2002 results.

Source: A.M. Best, Insurance Information Institute



# *P/C Industry Combined Ratio*



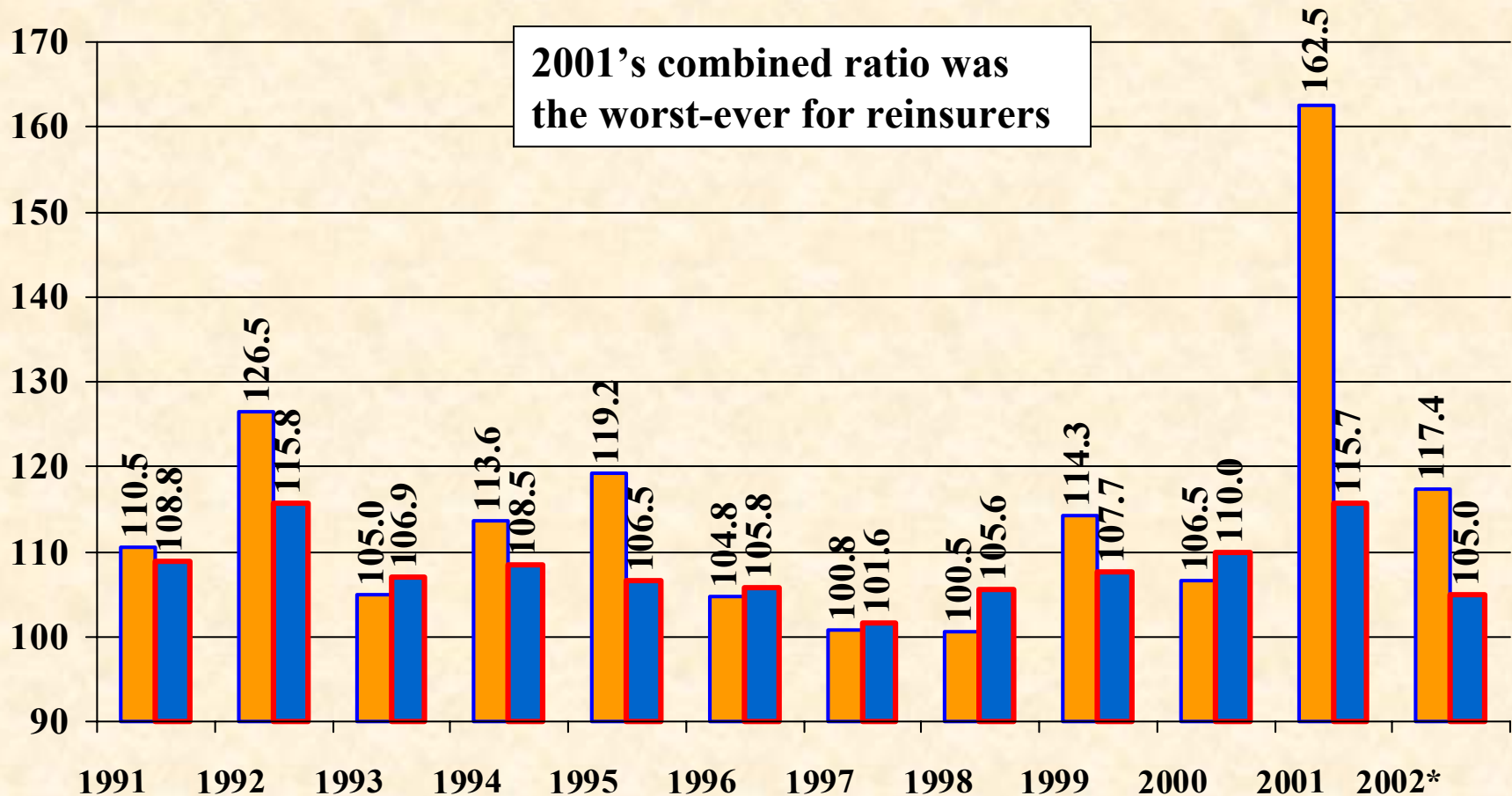
Sources: A.M. Best; III

\* Based on III 2002 Groundhog Forecast



# Combined Ratio: Reinsurance vs. P/C Industry

■ Reinsurance ■ All Lines Combined Ratio



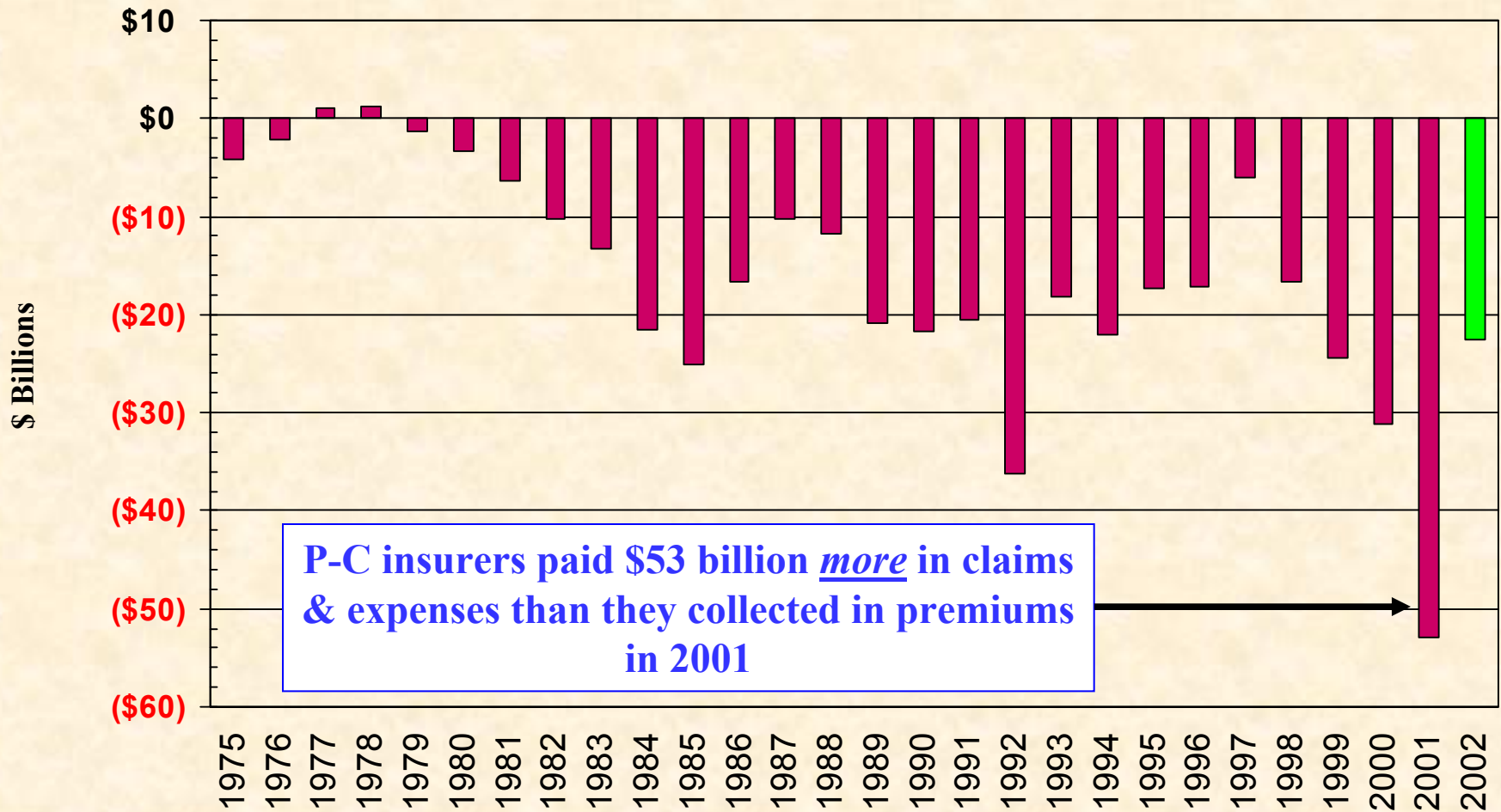
\*First Quarter 2002 figures.

Source: A.M. Best, ISO, Reinsurance Association of America, Insurance Information Institute



# Underwriting Gain (Loss)

## 1975-2002\*



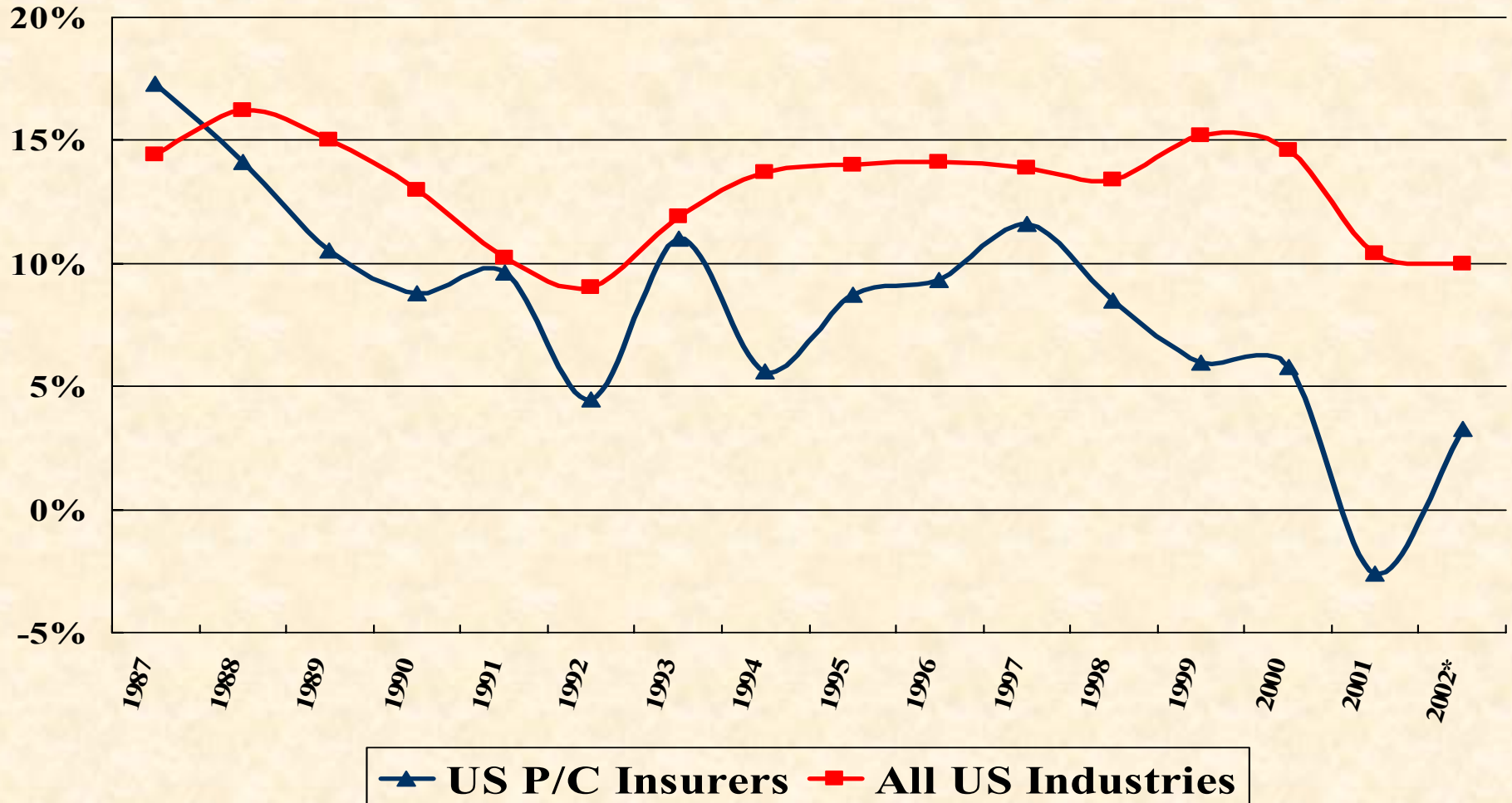
\*Annualized estimate based on first half 2002 data.

Source: A.M. Best, Insurance Information Institute



# ROE: P/C vs. All Industries

## 1987–2002\*

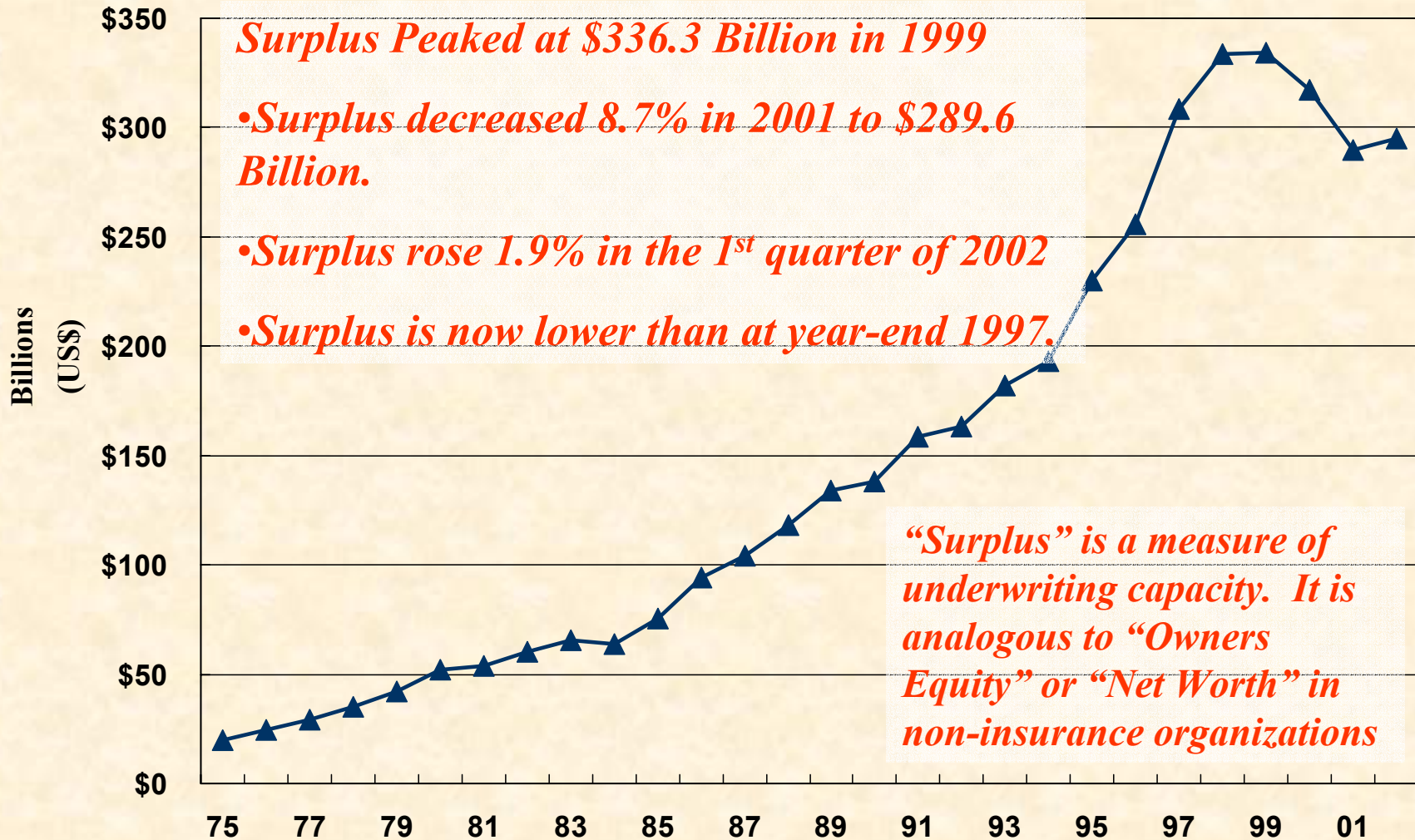


\*2002 figures are estimates; p/c figure based on first-half 2002 data.

Source: Insurance Information Institute; *Fortune*



# *Policyholder Surplus:* *1975-2002\**



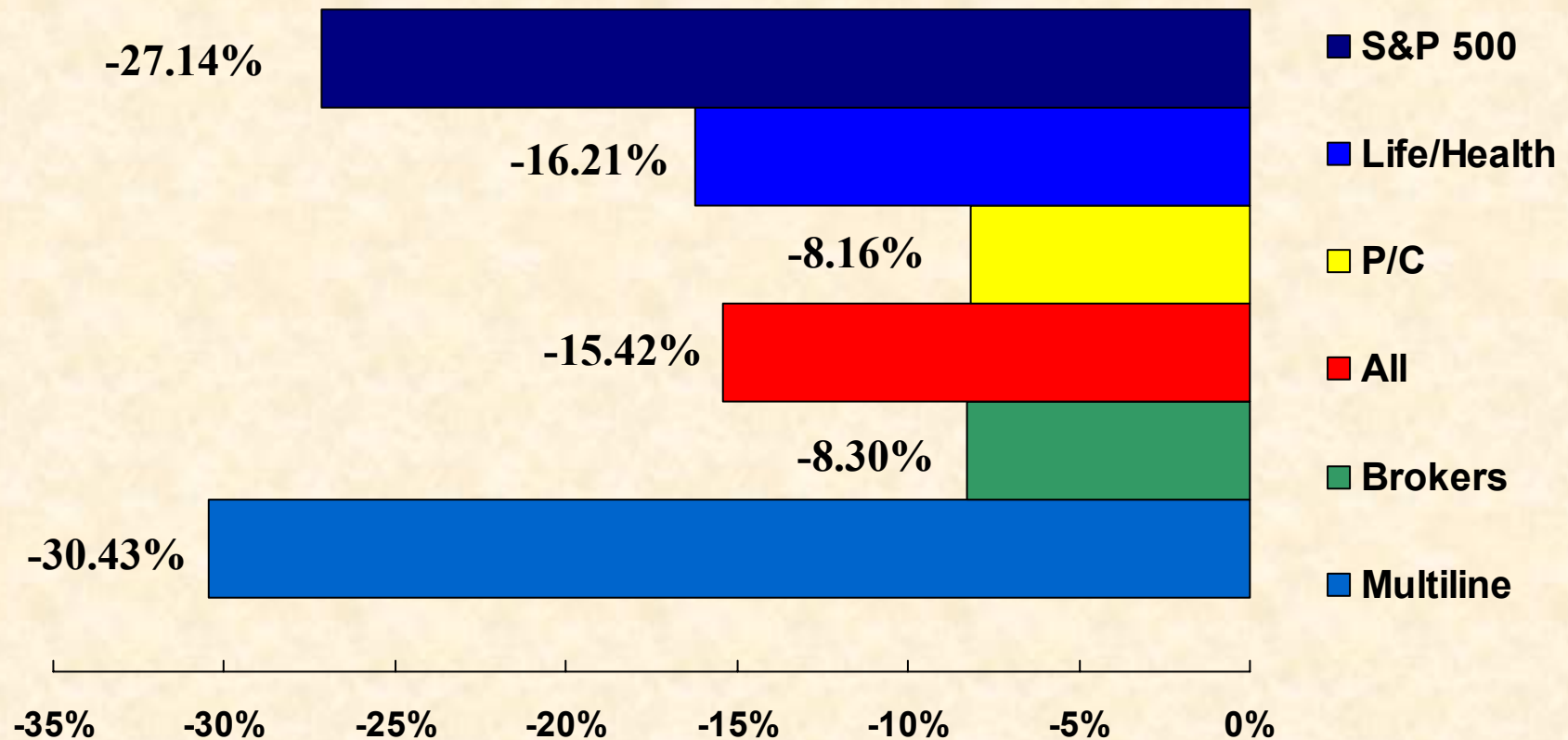
\*As of 1<sup>st</sup> quarter 2002

Source: A.M. Best, Insurance Information Institute



# *Insurer Stocks: Outperforming the S&P 500*

**Total Return 2002 YTD Through September 27, 2002**

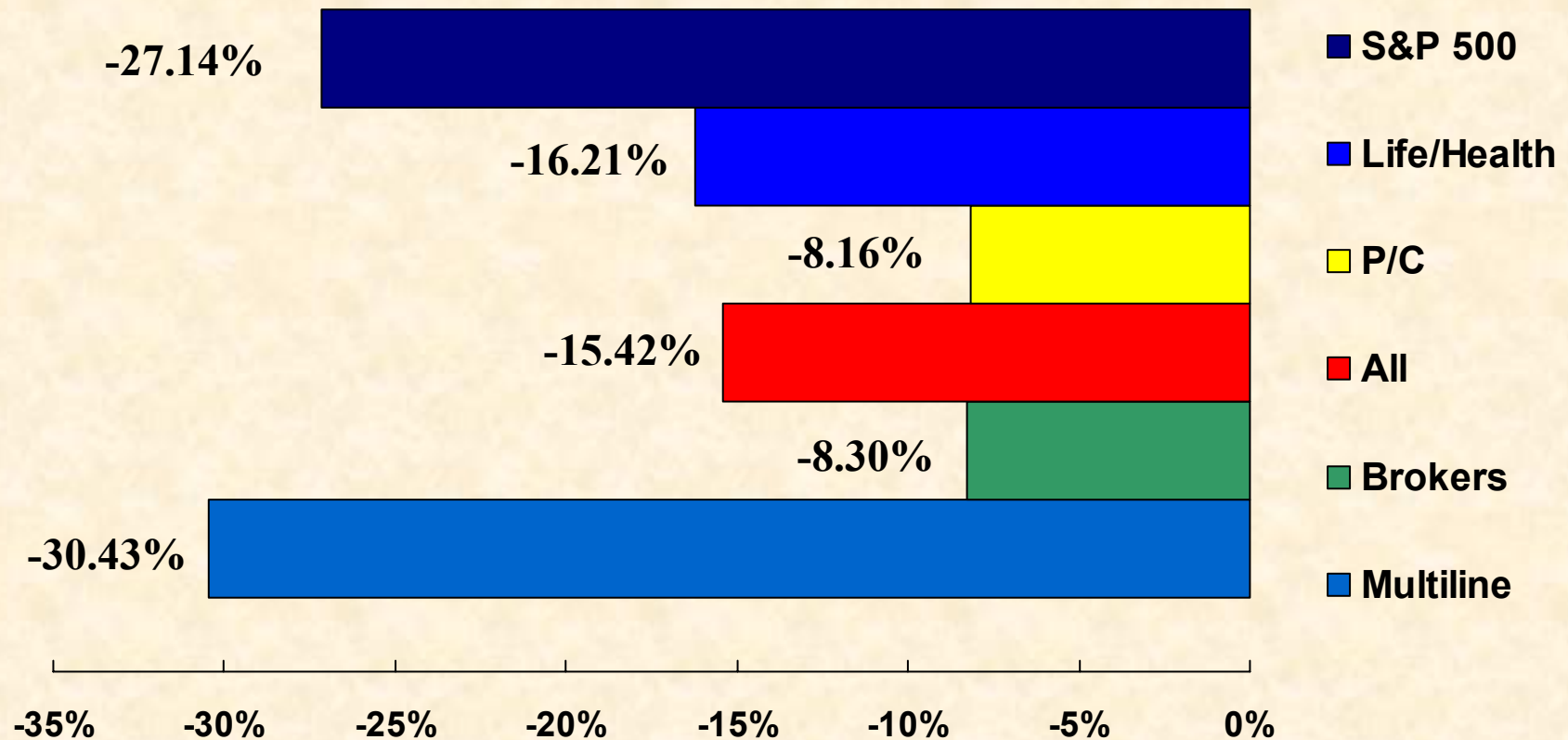


Source: SNL Securities, Insurance Information Institute



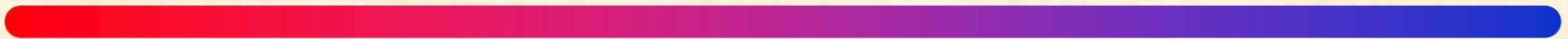
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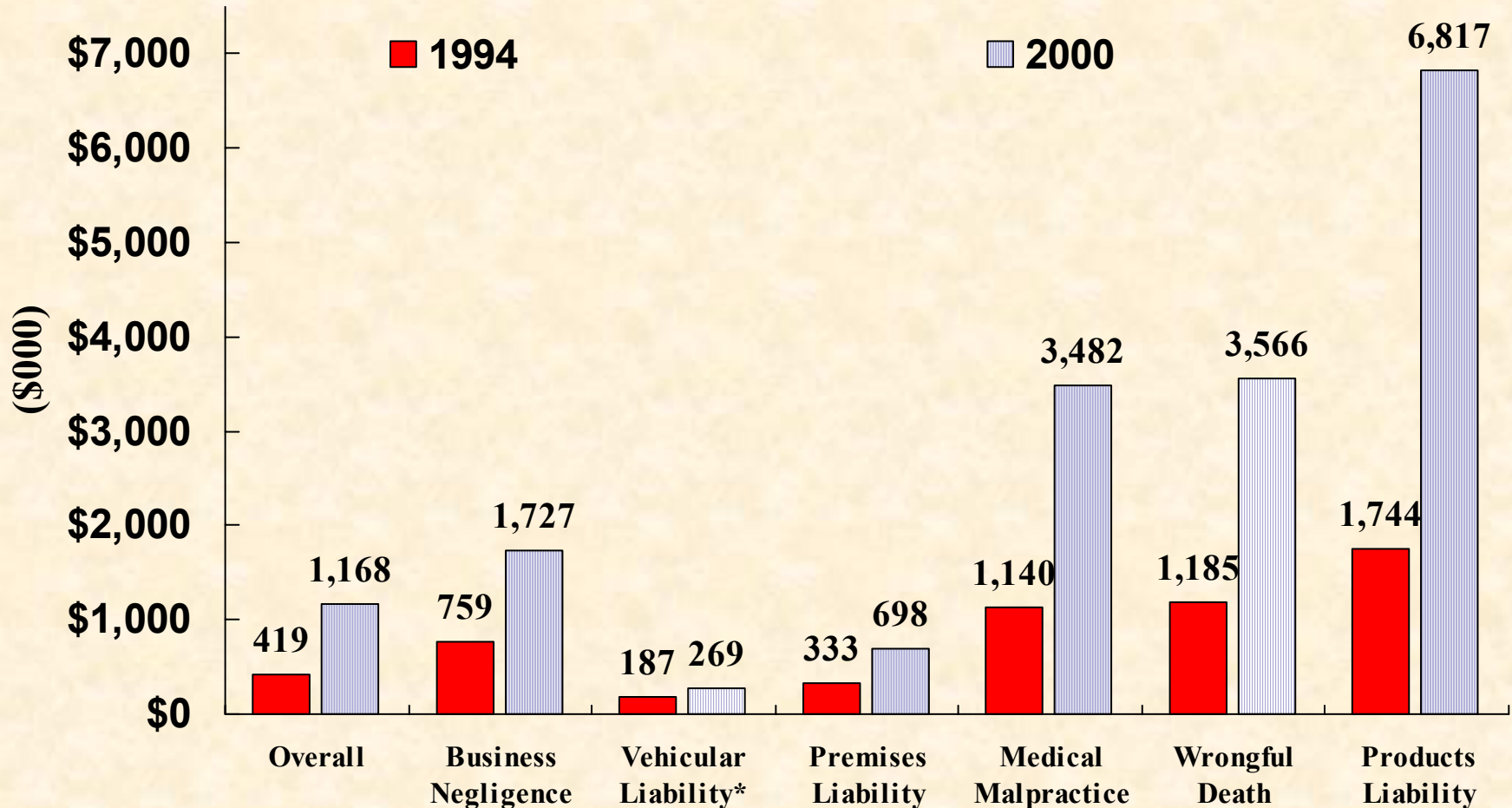
Source: SNL Securities, Insurance Information Institute

# *Abuse of the Tort System*





# Average Jury Awards 1994 vs. 2000



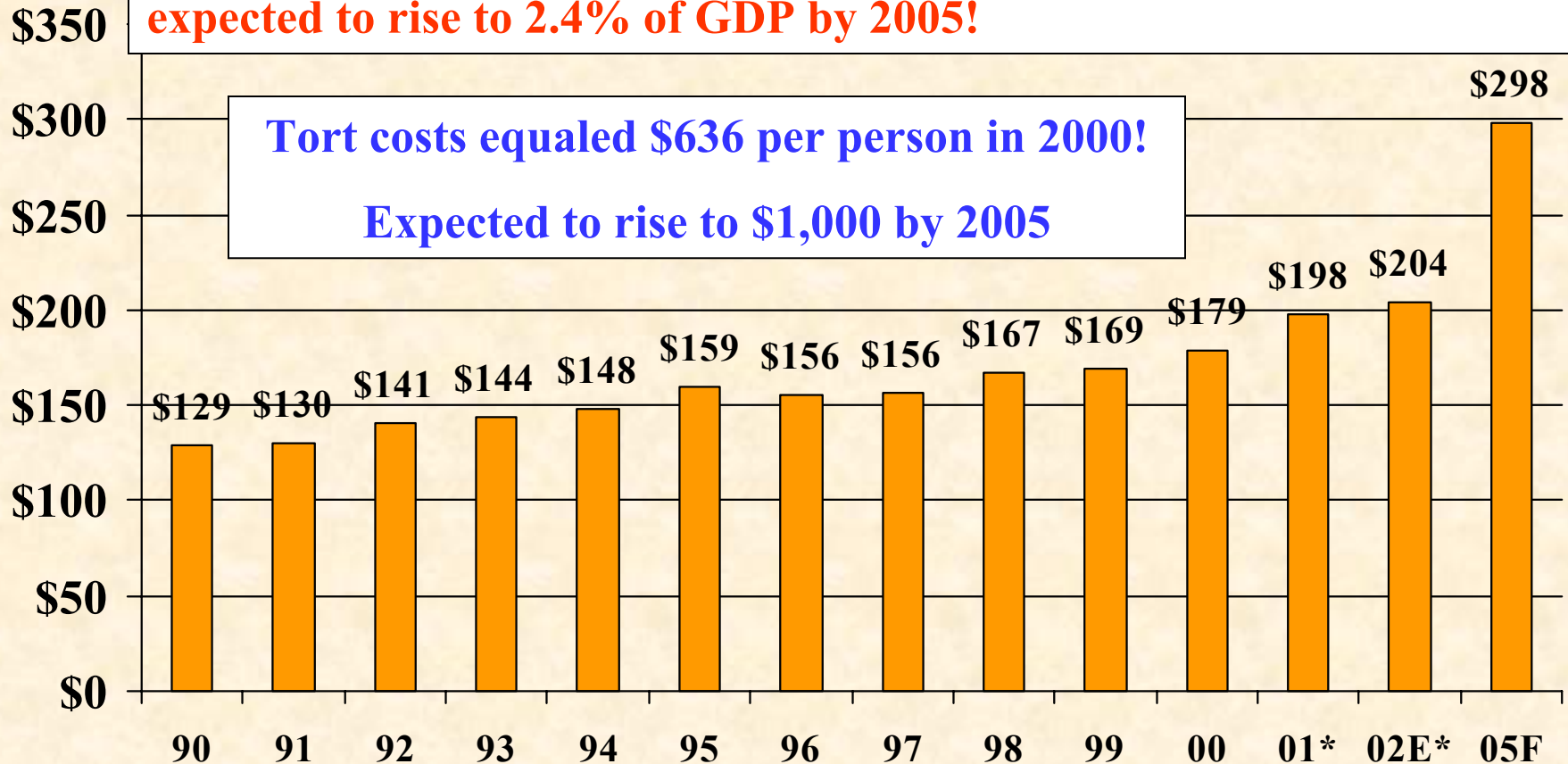
Source: Jury Verdict Research; Insurance Information Institute.



# Cost of U.S. Tort System

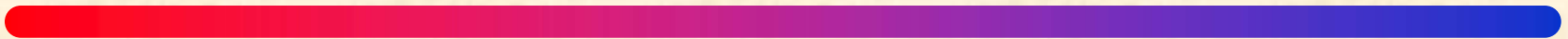
(\$ Billions)

**Tort costs consumed 2.0% of GDP annually on average since 1990, expected to rise to 2.4% of GDP by 2005!**



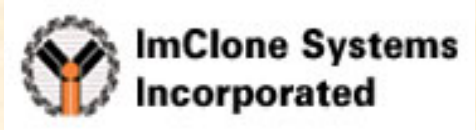
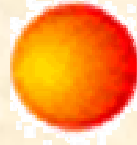
Source: Tillinghast-Towers Perrin; Insurance Information Institute estimates for 2001/2002 assume tort costs equal to 2% of GDP. 2005 forecasts from Tillinghast.

# *Corporate Governance*



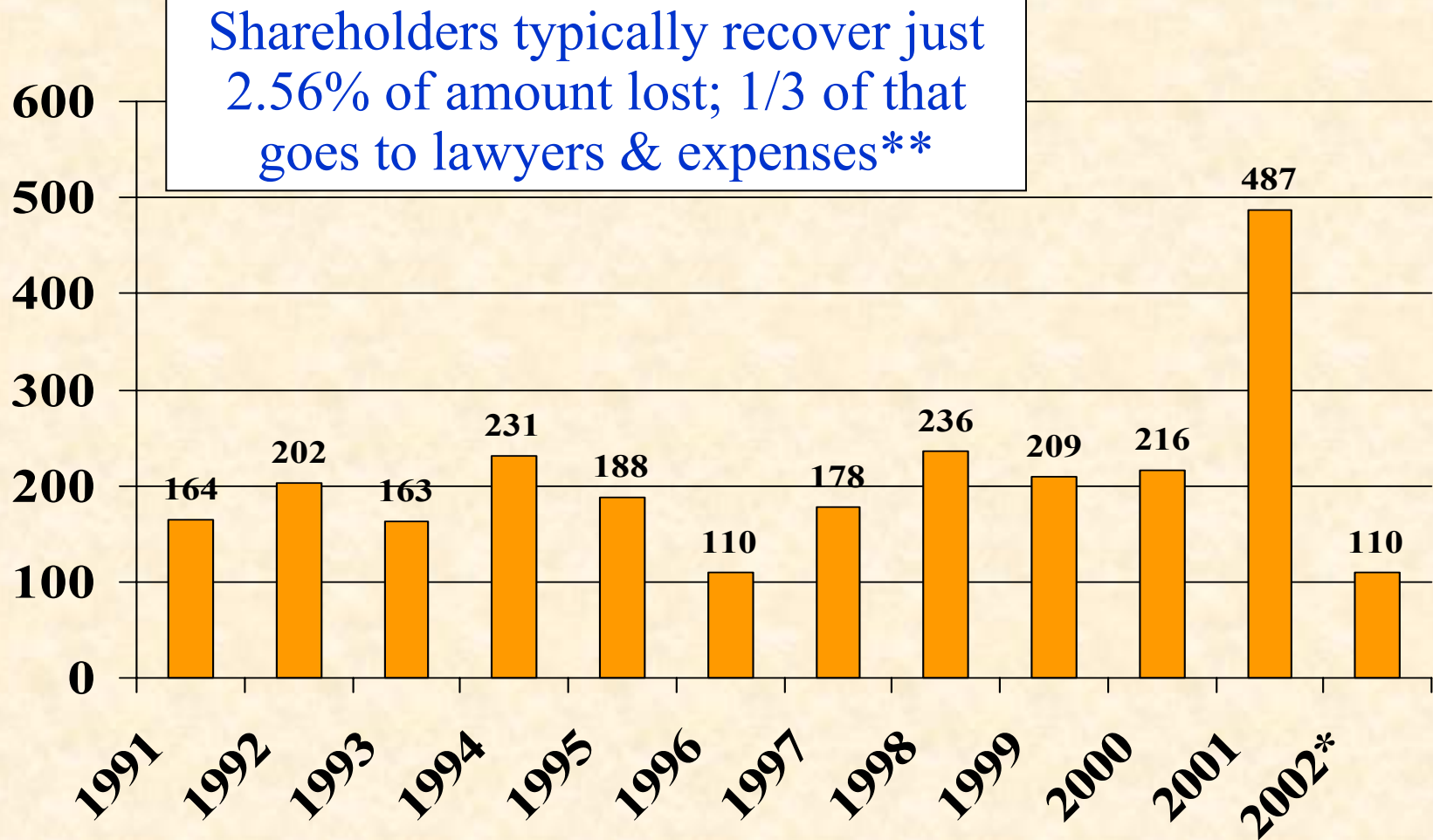
# *Accounting Problems are Getting Many Companies into Trouble*

- Enron was tip of an iceberg
- Major implications for insurers (p/c and life)





# Shareholder Class Action Lawsuits\*



\*Securities fraud suits filed in U.S. federal courts; 2002 figure is through June 14, 2002

\*\*Suits of \$100 million or more.

Source: Stanford University School of Law; Woodruff-Sawyer & Co.; Insurance Information Institute



# *Insurance Information Institute On-Line*

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