ROUTE TO:

THE RHA REVIEW

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Credibility GAAP: In Fact It's a GAAS. But It's Not, "All Right."

By Donald W. Bendure, CPCU, RPLU, ARM

Along with the opening of the Rolling Stones' World Tour, last year was filled with a multitude of momentous insurance and economic events that set the stage for 2003. Lloyd's of London got a new lease on life. Citigroup decided the insurance business wasn't so swell after all and sent Travelers packing. The insurance industry was itself terrorized by the federal backstop reinsurance that the insurance industry cried out for and got. (Be careful what you ask for … could this be the beginning of federal regulation? It has been shown that events can conspire.) The stalwarts of medical malpractice insurance vaporized in front of us with no apologies. Phantom asbestos claims somehow surfaced again with a vengeance. Premiums increased substantially (again) across the board, and property underwriters were once again restored to respectable status after too long being ignored. It's hard to believe that the era of the "two cent rate" is over. (Remember when everything was "two cents"?) Even Warren Buffet had to admit he made a mistake (but he claims it won't happen again). 2002 was in many respects a difficult year. If you don't think so, just ask Martha. She'll straighten your tie.

But few events from the past year have had an impact greater than what resulted from the absence of sound corporate governance. Remember 10 years ago when the heads of corporations like Apple, Kodak, IBM, and General Motors, among others, rolled at the behest of a mob of angry boards and stockholders? It was dubbed the "Year of Sharp Knives" and was intended to reshape expectations for management and usher in a new day of reason and rewards for performance. Somewhere between Apple and Enron, we forgot to tell the boards of directors that THEY had to do their homework as well. Not that they weren't paid well to know that already. The long answer is too involved to recite, but the short answer is that CEOs and CFOs were incentivized by boards to create a house of cards. Then the high-flying opiate of the "new economy" numbed everyone's senses, and we were drunk on the spirits of paper profits and "creative accounting." Boards asked questions, but the questions didn't penetrate the veil of creativity. Enron bled into Worldcom. Tyco and Adelphia confirmed the epidemic. Arthur Andersen bled to death as a result, and its insurers went into chronic shock syndrome, taking double hits from huge Directors' & Officers' and Errors & Omissions insurance losses.

> ***"The Sarbanes-Oxley Act of 2002 will cause a few sleep-less nights for many CEOs who will now want greater assurances that what they see is what they get."***

Congress attempted to legislate accountability. It is not the best of times to be either the CEO or CFO of a public firm. According to Citigate Global Intelligence & Security (www.citigategis.com), 80 percent of financial statement fraud involves either the company's CFO or CEO, or both. The Sarbanes-Oxley Act of 2002 will cause a few sleepless nights for many CEOs who will now want greater assurances that what they see is what they get. Directors' & Officers' liability insurance has never been in more demand while at the same time never more expensive or scarce. Errors & Omissions coverage is suffering from the same economics. Now we have a shortage of everything and everyone touching corporate finance and governance. Headhunters

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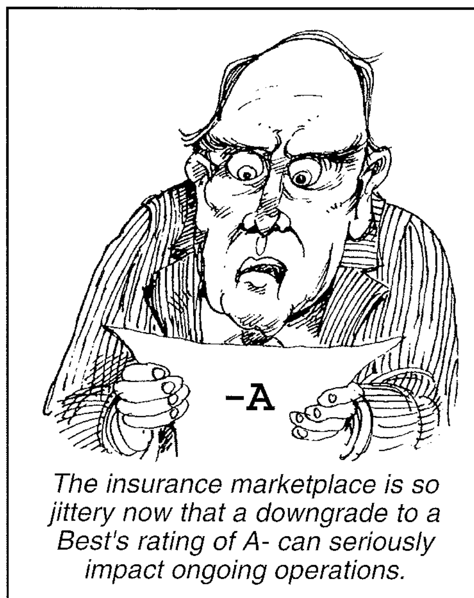
can't find enough "qualified" candidates for director positions, and everyone is decrying the lack of talent among the management ranks. *Competence* and *capability* are the watchwords for boards and management.

"At a recent international conference held by the Professional Liability Underwriting Society, it was boldly confessed that the property/casualty industry suffers from a lack of 'professionalism' at its highest levels."

Lo and behold, we are also awakening to this fact within the insurance industry ranks. At a recent international conference held by the Professional Liability Underwriting Society, it was boldly confessed that the property/casualty industry suffers from a lack of "professionalism" at its highest levels. Aside from this comment being understated, it is one problem that has not gone unnoticed by many for years. One panelist even maintained that "the fault always lies at the top." However, the truth even here was missed in part because the "top" is not the "highest levels of management." It is the board of directors. One major European insurer, when speaking about its scrutiny of board selection, stated that now "we are not just kicking the tires. We are putting them on the operating table, opening them up and seeing what we can find."

Many boards have become in large part a sham. This sad fact evolved, by management design, through "stacking" the board with a large percentage of "insiders." This is now starting to change, but not fast enough, and especially not fast enough in the insurance industry. One case in point is one large property/casualty insurer based in Texas that simply ceased operations in 2002. That's right — ceased operations, as in "Can't find anyone to buy this 'stuff'." It can be argued that this is also one reason why Best's downgraded 380 insurance companies in 2001, then downgraded 648 in 2002. The insurance marketplace is so jittery now that a downgrade to a Best's rating of A- can seriously impact ongoing operations. This was so even to the extent that for one well-known national insurer, a cut-through agreement had to be obtained in order to quiet the storm. There was a day when an A- was a respectable grade. See what poor corporate governance does to the curve? Rather than graduating "Cum Laude," it's now considered "Laude Laude."



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But this is not all bad. It is our job to make sure that good will rise out of these ashes. Patton once said that he never wanted to pay for the same real estate twice. Since we've already paid for these mistakes twice, how do we now make these lessons stick this time and put the word *govern* back in the word *governance*? We obviously learned little from the "Year of Sharp Knives" 10 years ago. How do we prevent history from repeating itself?

What has evolved as a result of all this carnage is a multifront attack. Institutional investors are now beginning to insist on a passing grade for boards in order to invest in a company. Tools have been developed in the marketplace to rate boards of directors. One such tool is the resources of the Corporate Library (www.thecorporatelibrary.com), which is a research group that will soon rate

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(**Credibility**, continued opposite)

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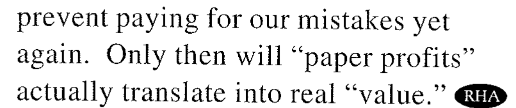
all boards just like we rate bonds – anywhere from AAA to "junk." This tool and others will prove invaluable for the Directors' & Officers' liability insurance carriers. The Public Company Accounting Oversight Board will no doubt have a few words to say about audit committees and how the errors and omissions exposure for audit firms may be mitigated. Citigate Global Intelligence & Security has developed what it calls the "board of directors tool kit" which helps companies comply with the Sarbanes-Oxley Act. Nyquil included for an additional fee.

One thing is certain: the ante has been increased considerably. Board members are understandably worried about their personal exposure. D&O and E&O carriers have pulled on the choke chain very hard over the last year. Talent is scarce, premiums are way up, policy limits offered are a fraction of the previous year, and retentions in some cases are reported as high as 50 percent. But new D&O and E&O insurance capacity is actually entering the market now, and this crisis of availability too will pass. With a healthy dose of history and homework, we can equip ourselves to prevent paying for our mistakes yet again. Only then will "paper profits" actually translate into real "value."



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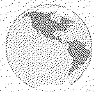
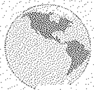
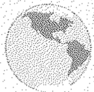
FROM NEAR AND FAR



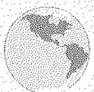
North Texas – The space shuttle *Columbia* was lost when it broke up upon re-entry into the earth's atmosphere at about eight o'clock central time on the morning of Saturday, February 1. *Columbia*, which was beginning its descent on its way to a landing at Cape Canaveral, Florida, was carrying a crew of seven, all of whom perished. The *Columbia* was on its 28th mission, the first of which was in April 1981. This was the 113th flight in the space shuttle program.



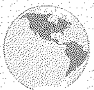
Hartford, Connecticut – According to reports in the January 20, 2003, edition of *National Underwriter*, Travelers Property Casualty Corp. has increased its reserves for asbestos-related claims by $2.45 billion to $3.4 billion.



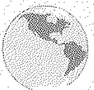
Rome, Italy – A spate of truck hijackings in Italy has led at least three Scandinavian insurers to attach strict conditions to their policies that cover the transportation of fish to Italy from Norway. According to a report in the January 20, 2003, edition of *Business Insurance*, 32 Norwegian trucks carrying fish have been hijacked on Italian roads since 1998. Ten trucks were hijacked during 2002 alone. Since 1995, $21.2 million worth of fish products have been stolen in hijackings in Italy.



Shanghai, China – According to Aon Corporation, it has become the first foreign company to be licensed to broker insurance in the Chinese market. Apparently operations will begin this summer.



Charlotte, North Carolina – The crash of U.S. Airways Express Flight 5481 on takeoff on January 8 was only one of three air disasters during that week. Twenty-one passengers and crew were lost in Charlotte when the twin-engine turboprop crashed into a maintenance hangar. The plane, operated by Air Midwest, Inc., has insurance coverage through its parent, Mesa Air Group, Inc. The plane was valued at a little more than $3.25 million. Mesa says it has $350 million in liability coverage.



On the same day a Turkish Airlines jet crashed while making its fourth attempt at landing in southern Turkey. Seventy-five of the 80 people on board were killed. Also, in Peru, a TANS Peru Fokker 28 crashed in a remote mountainous area outside of Chachapoyas, Peru. There were 42 passengers and crew on board.

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