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Risky Business: Insurers' Increasingly Risky Investments in Corporate America Cause Insurance Premiums to Skyrocket

> *"The most important factor that we're seeing is an increase in claims."*
> --Pete Moraga, insurance industry spokesman[1]

Why are consumer insurance rates are rising around the country? The insurance industry blames consumers, arguing that rate hikes are necessary due to the increasing expenses associated with insurance claims submitted by policyholders.

> *"In the last couple of years the average claim cost has gone up as much as 30% in some areas."* --Bill Sirola, State Farm spokesman[2]

The companies blame the increases on the allegedly rising costs of auto repairs, "mold litigation" and terrorism.

> *"And the costs per each claim are going up. For car insurance, labor costs are going up at body-repair shops. Doctor's bills are going up."*
> -- Lisa Wannamaker, Allstate spokeswoman[3]

Insurance companies do not, however, blame Enron and WorldCom for the rate hikes. More importantly, the companies do not blame themselves and the insurance executives who decided to risk a growing percentage of policyholder premiums by investing heavily in Enron, WorldCom and other corporations. They should. And insurance commissioners should hold insurance companies accountable for the billions of policyholder premium dollars that have been squandered as a result this risky business.

1. Americans are more exposed to corporate corruption than they think

With the excitement surrounding the stock market bubble of the 1990s, insurance companies put policyholder premiums and money reserved to pay losses at greater risk by increasingly investing in private corporations. Typically, insurance industry executives assert that company portfolios are largely tied up in municipal and other government bonds, with only limited exposure to corporate America. However, by 2001, the particularly disgraced energy, high-tech and telecom sectors figured heavily in insurance companies' portfolios. As a result of this indulgence in higher risk

[1] "Home Policy Rules Tighten," by Wailin Wong, *Orange County Register* April 27, 2002
[2] "State Farm Won't Write New Homeowners Policies, by E. Scott Reckard, *Los Angeles Times* April 23, 2002
[3] "At a premium: Insurance rates climbing – with no end in sight," by Dean Calbreath, *San Diego Union Tribune*, March28, 2002

investments, the spate of recent corporate scandals and the insurers' investment follies pose a significant threat to consumers whose premium dollars have been placed in insurance company portfolios replete with stocks and corporate bonds.

The 15% to 30% rate hikes common to many insurance consumers these days are not attributable to the reported rise in claim costs, as the insurers argue, but are due to the significant investment losses sustained by insurers in recent months. This study highlights some of the billions of premium dollars lost as a result of changes in property and casualty insurers' investment strategies.[4]

Among FTCR's findings:

- State Farm Mutual Auto has already lost $60.7 million on ***WorldCom*** investments this year. The weak telecom sector has also cost State Farm, the nation's largest insurer, $42.6 million in losses associated with its ***Tellabs*** holdings.

- Allstate lost $23.3 million when it shed several hundred thousand shares of ***Tyco*** stock as the public became aware of Tyco CEO Dennis Kozlowski's alleged criminal fraud in the first half of 2002. The insurer also lost $11.7 million when it discarded ***Qwest Communications*** stock, another firm investigated by the SEC for its accounting practices.

- Fireman's Fund wrote off the entire cost of its ***Winstar*** stocks and bonds – $85.4 million – last year after that wireless communications company filed for bankruptcy in April 2001. Additionally, the insurer took a $28.6 million hit on ***WorldCom***.

The Enron factor:

- ***Enron***, the company whose fraudulent accounting and subsequent bankruptcy inaugurated the current era of corporate scandals, was held by many of the insurers reviewed for this analysis. In 2001, Enron losses cost State Farm Mutual Auto $13.5 million, Farmers $9 million, Fireman's Fund $6.2 million, Northern California Auto Club $4.4 million, Southern California Auto Club $1 million, United Services Automobile Association $4.3 million and Allstate $3.6 million. Fireman's Fund continues to hold $5 million dollars in Enron bonds.

2. Policyholders: The backstop for insurer mismanagement

The executives and investment teams in the insurance industry should have known better. They have decades of experience instructing them to invest conservatively. As is set forth in the preamble to the International Association of Insurance Supervisors' "Supervisory Standard on Asset Management by Insurance Companies":

> *In order to ensure that an insurer can meet its contractual liabilities to policyholders, such assets must be managed in a sound and prudent manner taking account of the profile of the liabilities held by the company and, indeed, the complete risk-return profile.*[5]

[4] All data are based on Annual Statements of insurers filed with the California Department of Insurance. Calculations of stock and bond holdings are based on the actual cost of the investments (see also footnote 8).

[5] "Supervisory Standard on Asset Management by Insurance Companies,"International Association of Insurance Supervisors. Approved December 1999

But, as this report shows, the companies ignored their responsibility and, blinded by greed, jumped headlong into the stock market bubble — only to fall hard when it burst with the string of frauds and bankruptcies that has decimated the Dow and NASDAQ in recent months.

The mismanagement of policyholder premium, however, has been largely ignored as companies, instead of biting the bear market bullet, simply replenish the dissipated investments through rate hikes.[6] Indeed, there is a correlation – known as the "insurance cycle" – between rate increases and a bear market. When investment return is strong, rates remain stable, but when there is a downturn in the market, insurers seek rate increases to maintain high profit levels. As a result of insurers' increased exposure to corporate risk during this insurance cycle, the impact of corporate fraud on companies and, in turn, policyholders was far greater than should ever have been expected.

3. The big five frauds cost ten insurers a quarter billion dollars

When the stock market bandwagon came to a screeching halt during the corporate crime wave of 2001-2002, the insurers' foray into the market caught up with them. Many of those insurance companies that were highly exposed to the "new economy" side of the market faced severe fraud related setbacks. The ten property and casualty insurance companies reviewed for this study lost a combined $274.1 million in 2001-2002 as a result of investments in *The Big Five Frauds* – WorldCom, Enron, Adelphia, Global Crossing and Tyco.[7] State Farm lost more than $74 million as a result of that company's investments in Enron and WorldCom alone.

The losses sustained by insurers when the fraudulent behavior at these corporations came to light flows very quickly into the premiums charged by insurers. In other words, <u>insurance rates are rising because of Enron and WorldCom.</u>

4. Insurers increase level of corporate investment

FTCR studied investment data for ten major insurers doing business in California and nationwide for the last four years for which data is available (1998-2001). The study also examined available 2002 data, and reviewed data going back to 1994 for four companies exhibiting the riskiest investment behavior.

For this analysis, FTCR reviewed public filings to measure the percentage of an insurer's portfolio that is invested in stocks (both common and preferred) and corporate bonds.[8] The study did not review real estate holdings, which are reported separately from stock and bond holdings.

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[6] Insurance companies maintain significant surplus, beyond what is reserved to pay losses, that could be tapped to cover claims if there is a shortfall due to failed investments of policyholder premium.
[7] The companies reviewed include: Allstate Insurance Company, Auto Club of Northern California, Auto Club of Southern California, Farmers Insurance Exchange, Fireman's Fund, Liberty Mutual Insurance Company, Mercury Casualty Company, Nationwide Mutual Insurance Company, State Farm Mutual Auto, United Services Automobile Association.
[8] This percentage was calculated using the actual cost of insurers' investments, also known as the purchase price. The purchase price of the insurance companies' stock and bond holdings in a given year remains constant, while other measures – such as book value – may fluctuate. Moreover, the actual cost of the investments is useful in that it shows

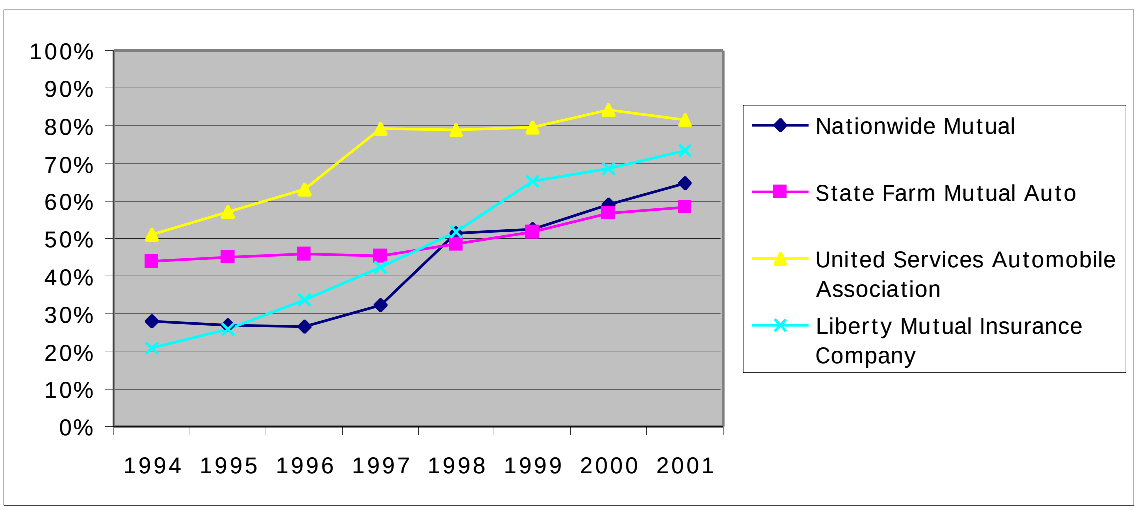
Nine of the ten companies reviewed increased their level of investment in the corporate sector between 1998 and 2001. The companies' holdings in 1998 consisted on average of 48% stocks and corporate bonds combined, with the rest invested in government bonds. By 2001, the average percentage invested in corporate America was up to 57% -- a 19% increase in the size of insurers' corporate investments relative to their overall portfolios. At the end of 2001, seven of the 10 companies for which FTCR obtained data had over 50% of their investments in stocks and corporate bonds.

For four of the companies that had most heavily invested in the stock and corporate bond markets in 2001 – USAA, Liberty Mutual, State Farm and Nationwide – FTCR analyzed portfolios for an extended period, 1994-2001, and found that the companies had greatly increased investments in the corporate sector relative to their overall investments.

- In 2001 United Services Automobile Association had more than four-fifths of its entire portfolio – 82% – invested in the corporate sector. This represents a 61% increase in the companies' investments in corporations since 1994.
- Corporate investments accounted for 73% of Liberty Mutual's portfolio in 2001, representing a 248% increase over the insurer's 1994 corporate investments, which accounted for 21% of its portfolio
- State Farm Mutual Auto's percentage was 58% in 2001, a 32% increase over its level of corporate investing before the company jumped into the nineties stock bubble.
- Nationwide Mutual's ratio of corporate investments to its overall holdings jumped 37 percentage points over this period to 65% – a 132% increase.

The following graph shows the rise in the percentage of these companies' portfolios tied up in corporate sector investments.

Corporate Investment as a % of Investment Portfolio 1994-2001



how the companies in this study chose to allocate their investment dollars over the years. In other words, if a given company's level of investment in corporations grew over the period of the study, it was not due to rising values of previously purchased stocks and corporate bonds. The use of the actual cost value is also consistent with the losses on stock and bond sales and write-offs listed below, which are calculated based on the initial purchase price of the investments.

5. Heavy in stocks

It is important to note that a large portion of corporate holdings is invested in stocks and not in the generally more stable corporate bonds. As the following chart indicates, insurance companies have moved an increasing amount of their investments into stocks. Similar charts presenting the data for corporate bond investments and combined stock and bond data are contained in Appendix 1.

Stock Holdings As Percentage of Investment Portfolio

Company	1994	1995	1996	1997	1998	1999	2000	2001
United Services Automobile Association	40%	36%	38%	46%	48%	52%	54%	57%
Nationwide Mutual Insurance Company	25%	24%	24%	26%	44%	43%	47%	46%
State Farm Mutual Auto	27%	26%	27%	27%	29%	33%	40%	43%
Liberty Mutual Insurance Company	10%	13%	15%	21%	27%	37%	39%	42%
Farmers Insurance Exchange					32%	36%	41%	39%
Allstate Insurance Company					19%	20%	21%	20%
Fireman's Fund					38%	47%	51%	32%
Auto Club of Northern California					22%	N/A	N/A	29%
Mercury Casualty Company					33%	32%	28%	27%
Auto Club of Southern California					18	N/A	N/A	19%

N/A: Not available when data was compiled.

The stock investments of the ten companies reviewed averaged 37% of their overall investments in 2001, eight percentage points more than 1998 levels. United Services Automobile Association invested more than half of its portfolio –57% – in stocks alone (up from 40% in 1994). Nationwide Mutual was close behind with 46% (a the company invested only 25% in stocks in 1994), and State Farm Mutual Auto's stock holdings represented 43% of its portfolio (compared to 27% in 1994). 42% of Liberty Mutual’s holdings were in stocks in stocks in 2001, up from 10% in 1994.

6. Insurers pick the losers

Insurance portfolios are replete with corporate stock and bond picks that chronicle the recent bankruptcies, earnings restatements and fraud indictments. A glance at stock and bond transactions in 2001 for a handful of big insurance companies illustrates how they slashed investment income by remaining too heavily invested in the stock and corporate bond markets. And the early 2002 data is even worse, as a series of massive bankruptcies hit Wall Street.

The 2001 figures below represent the sum of the amounts lost by a given insurer on all transactions of a given company's stocks and bonds for the entire year, 2001.

A Selection of Insurers' Major Stock and Bond Losses in 2001[9]:

Allstate	**Fireman's Fund**
· Adelphia: $1.1 million[10] · AOL / Time Warner: $2.2 million · Cisco: $6.9 million · Enron: $3.6 million · Global Crossing: $5.9million · Qwest: $11.7 million · WorldCom / MCI: $2.4 million	· Broadcom: $31.2 million · Cisco: $26.3million · Enron: $6.2 million · WorldCom / MCI: $28.6 million · Winstar: $85.4 million
Farmers	**Nationwide**
· Enron: $9 million · Dynegy: $1.1 million	· Enron: $734,513 · EMC Corp.: $4 million · Compaq: $1.2 million
NorCal Auto Club	**Safeco**
· Enron: $4.4 million · Tyco International: $1.3 million	· Global Crossing: $2.3 million · Lucent: $2.9 million
State Farm	**USAA**
· Enron: $13.5 million · Level 3 Communications Inc: $55 million · Bank of America: $29.1 million · XO Communications Inc.: $19.8 million · Battle Mountain Gold: $9.9 million	· Enron: $4.3 million · JDS Uniphase (telecom supplier): $7.6 million · USAA emerging markets fund: $63.6 million (fund heavily invested in international energy and telecommunication stocks)
SoCal Auto Club	
· Enron: $1 million · WorldCom / MCI: $0.9 million	

The insurance companies' most recent filings show that their stocks continued to slide through the first half of this year. In early 2002, revelations of accounting fraud at Tyco, Adelphia, WorldCom and Qwest hit the front pages, while numerous other companies restated earnings or failed to meet profit forecasts. The value of some of the insurance

[9] All of a given company's publicly traded units are grouped for the purposes of this report. For example, "WorldCom" includes MCI and WorldCom, "AOL / Time Warner" includes AOL and Time Warner, etc. "Williams" includes Williams Cos. and Williams Communications Group, due to the Energy company having been the owner of the Communications subsidiary during a portion of the period covered by this report and the continuing close affiliation between the two companies.

[10] Figures for stock and bond losses are based on total net gain / loss from all transactions of the given issuer's stocks and bonds, and / or basis adjustments for bonds, for each insurer.

companies' stock and bond holdings hit rock bottom during this period, and insurers racked up huge losses as they bailed out of their bad investments. 2002 figures reflect data from the first two quarters of the year, unless otherwise noted.

Insurers' Major Stock and Bond Losses During 2002[11]:

Allstate	Fireman's Fund
· Adelphia: $1.2 million · AOL/Time Warner: $11 million · AT&T: $7.2 million · Cisco: $7.4 million · Oracle: $3.1 million · Qwest: $6.4 million · Tyco: $23.3 million · WorldCom: $20.4 million	· Adelphia: $1.9 million · AOL/Time Warner: $32.7 million · Applied Materials Inc.: $13 million · Global Crossing: $8.2 million · Qualcomm: $12.1 million · Qwest: $17.7 million · Tyco: $7.6 million · Williams: $4.5 million · WorldCom: $40.1 million
Farmers[12]	**Mercury**
· Qwest: $2 million · WorldCom: $2 million	· Mirant: $2 million · Qwest: $1.2 million · Sprint: $2.9 million
State Farm	**USAA**
· WorldCom: $60.7 million · AES: $9.9 million · Charles Schwab: $11.4 million · Honeywell: $24.8 million · Lucent: $7.6 million · Tellabs Inc. (telecom supplier): $42.6 million	· AES: $1.7 million · AOL/ Time Warner: $9.3 million · AT&T: $10.1 million · Cisco: $1.3 million · Qwest: $10.6 million · Tyco: $4.6 million · WorldCom: $13.1 million
SoCal Auto Club	**Nationwide**
· Qwest: $1.3 million · Tyco: $1.2 million · WorldCom: $4.6 million	· Hanover Compressor $1 million

7. Not over yet: Insurers still own bankrupt WorldCom's stocks and bonds.

The above selected stock and bond losses illustrate how, by making bad investments, the insurance companies have weakened the value of policyholder premium. The effects of fraud are not fully tallied. Insurance companies' losses will grow when they eventually account for the obliteration of their WorldCom holdings' value. The companies reviewed that are still holding on to WorldCom stocks and bonds, in descending order of the cost of the investments:

State Farm Mutual Auto	$49 million (bonds)
Farmers	$28.4 million (bonds)
Southern California Auto Club	$15.8 million (bonds)

[11] Data from insurance companies' first and second quarter statements filed with the California Department of Insurance.
[12] 2002 investment data for Farmers Insurance Exchange from first quarter 2002 only.

Fireman's Fund[13]	$13.2 million (bonds)
Liberty Mutual	$6.6 million (bonds)
Northern California Auto Club	$6.2 million (stocks and bonds)
Safeco	$1.7 million (bonds)

8. Conclusion: Insurance commissioners and lawmakers must step in

The investment losses and other data detailed above are not meant to be exhaustive. They paint a picture, rather, of the sort of investment failures that have cut into insurance companies' profitability in the past year. One mostly overlooked, but tragic, consequence of the recent corporate frauds is that small investors, who have already seen their own portfolios and pensions drained, are being forced to shell out more cash to cover what the insurance companies lost when they gambled in the markets.

Insurance commissioners throughout the nation should intervene on behalf of consumers and bar companies from passing the companies' failed investment portfolio on to policyholders when companies' indulge recklessly in corporate investments. Where commissioners do not have sufficient regulatory authority, lawmakers should develop new rules to protect policyholders from this kind of financial double jeopardy in which consumers suffer their insurer's investment losses in addition to their own.

When companies devalue the premium dollars entrusted to them by policyholders, through risky portfolios, the companies should be required to bear the consequences. If insurance companies continue to receive a green light to pass through their investment mistakes to policyholders, insurers will have an incentive to pursue high-risk investments, knowing that policyholders will absorb the risks of corporate fraud and a bear market, while the companies reap the benefits of the bull markets.

[13] As noted above, in addition to holding on to its WorldCom bonds, Fireman's Fund continues to keep $5 million dollars in Enron bonds.

Appendix 1

Corporate Bond Holdings As Percentage of Investment Portfolio								
Company	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Allstate Insurance Company					15%	18%	17%	18%
Auto Club of Northern California					9%	N/A	N/A	27%
Auto Club of Southern California					9%			24%
Farmers Insurance Exchange					21%	25%	28%	26%
Fireman's Fund					30%	28%	26%	27%
Liberty Mutual Insurance Company	11%	13%	19%	21%	24%	28%	30%	31%
Mercury Casualty Company					0%	0%	8%	14%
Nationwide Mutual Insurance Company	3%	3%	3%	6%	7%	10%	12%	18%
State Farm Mutual Auto	17%	19%	19%	19%	20%	19%	16%	15%
United Services Automobile Association	12%	21%	25%	33%	31%	31%	31%	24%

Stock and Corporate Bond Holdings As Percentage of Investment Portfolio								
company	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Allstate Insurance Company					33%	38%	37%	37%
Auto Club of Northern California					31%	N/A	N/A	56%
Auto Club of Southern California					27%	N/A	N/A	42%
Farmers Insurance Exchange					53%	62%	69%	65%
Fireman's Fund					68%	75%	77%	59%
Liberty Mutual Insurance Company	21%	26%	34%	42%	52%	65%	69%	73%
Mercury Casualty Company					33%	32%	37%	41%

Nationwide Mutual Insurance Company	28%	27%	27%	32%	51%	53%	59%	65%
State Farm Mutual Auto	44%	45%	46%	45%	49%	52%	57%	58%
United Services Automobile Association	51%	57%	63%	79%	79%	80%	84%	82%