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TITLE NEWS

Slaying the IBNR Monster

TITLE NEWS

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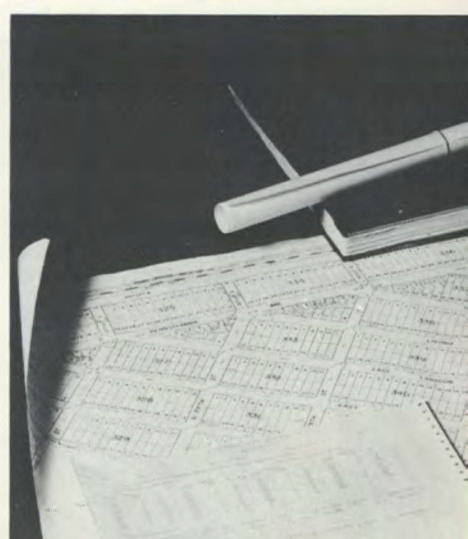


A Message From The President-Elect

Now that the excitement and expectancy of a new administration has diminished, it is a good time to consider the immediate future of the economy and of the title insurance industry. It is no longer necessary to consult an expert or a seer to predict that 1981 will be, at least, a year of adjustment with continued weakness in those areas of the economy upon which our industry relies.

When this forecast is superimposed upon the past year's dismal statistics, it is difficult to project any other picture but one of disappointment and frustration.

Yet, as incredible as it may seem at the moment, the country and our industry have survived economic setbacks more severe than those from which we are, hopefully, emerging. The lessons of the past suggest that those who are most prepared for the future are most likely to effect the kind of dramatic recovery that we would like to anticipate.

Unfortunately, all of our efforts toward improvement of service, reduction of costs and expansion of coverage will not overcome the effects of a controlled market in which real competition is impossible. Arrangements through which those who control title insurance referrals become agents in order to receive payment for such referrals must reduce or eliminate the potential for others to compete.

The legitimate agent is independent in the sense that he is an entrepreneur engaged in marketing his own services as well as his underwriter's product. In many respects the independent agent is more of a victim of controlled business practices than the underwriter and consumer who share the cost of such arrangements. While the insurer may succumb to the demands of controllers of business and make an uneasy peace with them, every controlled business agency represents, to the independent agent, a reduction in the size of the market.

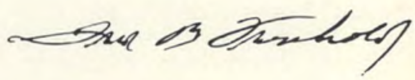
The agency system has been a fundamental method of marketing title insurance almost from the inception of the industry. The proliferation of agents is testimony to the extent to which developing title insurance business is a function of personal service and appeal. In recent years, the operations of independent agents have achieved a high level of sophistication. In many instances, agents have been able to realize a greater degree of operating efficiency than the underwriters that they represent.

Title insurance agents have played a major role in the history of the industry. Much of the credit for the broad base of acceptance which the industry now enjoys must be given to agents who pioneered the sale of our product in areas in which title insurance was unknown or scarcely understood.

Independent title insurance agents have, in increasing numbers, voiced their complaints about the effects of controlled business arrangements upon their survival.

Some agents are reconsidering their affiliation with underwriters who persist in such practices. These agents, as individuals, do not have the resources to engage in a protracted fight to keep their market areas open for competition, but as part of the industry's organized efforts to combat anti-competitive practices, agents can channel their anger into constructive and effective activity.

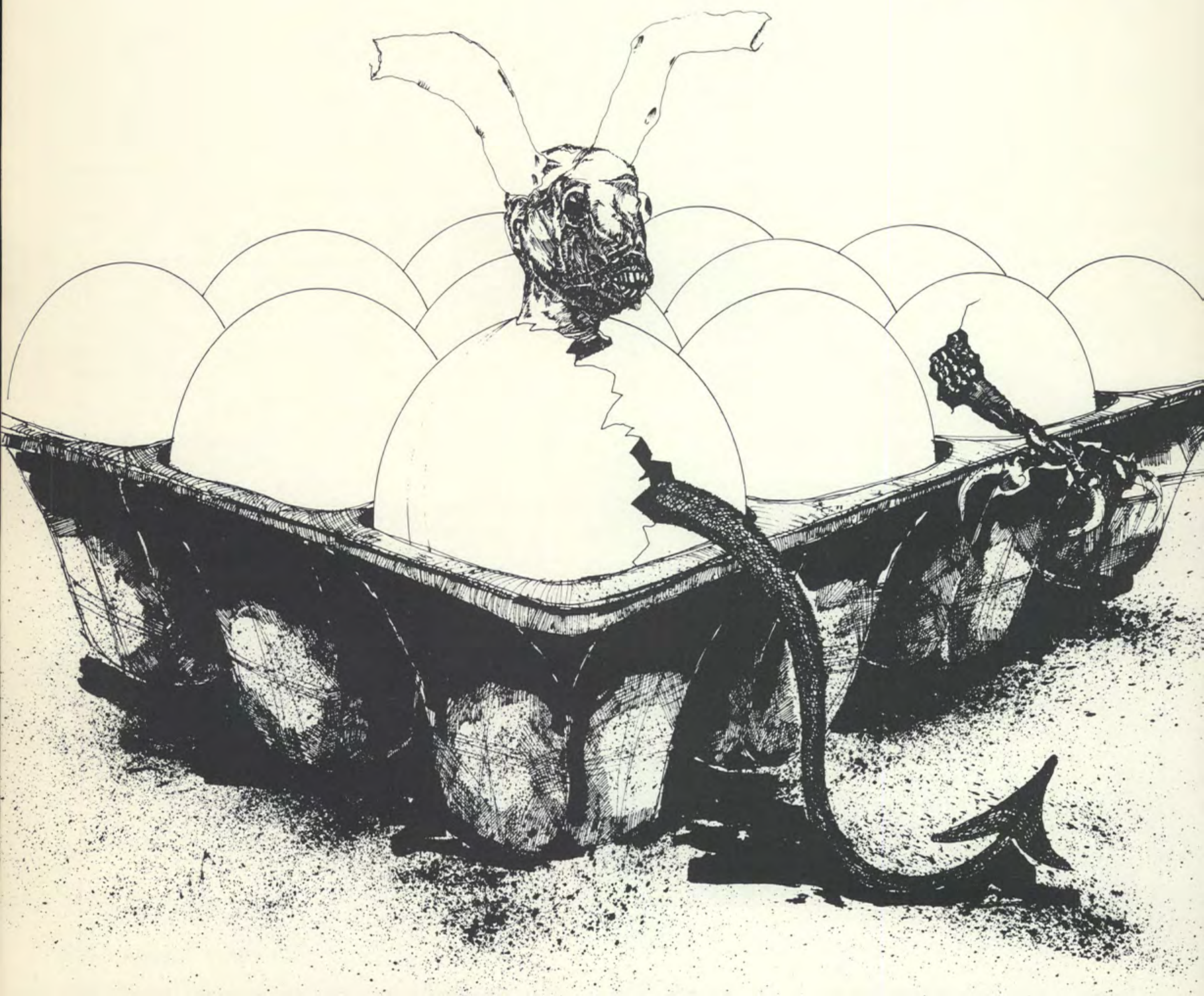
As we sharpen our tools in preparation for improvements in the economy, we must continue our efforts to insure that increased business activity will result in increased business opportunity for both underwriters and agents.



Fred B. Fromhold

Accounting Procedure—Slaying the IBNR Monster

by John E. Jensen



The title industry's management of the cost of claims and losses as a charge against earnings was a relatively simple affair prior to the years 1974 and 1975. The experience of most companies, and of the industry as a whole, was stable. Losses as a percentage of revenue for any particular year generally ran between two and four percent. And, years with a four percent loss experience in terms of payments and known pending claims were considered very bad years.

As a result of the stability of historic loss experience, almost all companies in the industry provided for losses on their financial statements by merely extrapolating past experience. The extrapolation took all sorts of forms—three-year average loss experience, five-year average loss experience, five-year rolling averages and so on. Regardless of the methodology used, this historic paid-pending approach proved to be adequate in providing both management and auditors a satisfactory comfort level in relation to the size of the charge against current earnings.

In 1974, the world began to change rapidly. It was at that time, that the eggs of a service called Construction Disbursement Guarantees hatched and gave birth not to cute little chicks, but rather to dragons—identified as monstrous losses. Even after we had slain that dragon—and some of us even today still have little pieces of the tail twitching—we discovered that our losses as a percentage of current year's revenue had crept up to seven, eight and even 10 percent, as opposed to the historic two to four percent.

In part, this was the result of inflation where we were issuing more and more policies with higher face amounts of insurance. Our revenue does not grow proportionally with the increase in face amounts of insurance. It would appear, however, that our claims do. Compared to property casualty companies, even a 15 percent loss ratio would be considered insignificant since in our sister industry loss ratios are not uncommon at a 60 percent level. But for us, going from four to eight percent, for example, is in effect a doubling of our loss experience and has a major impact on the profitability of our industry where margins are narrow, at best.

A New Monster

It was about this same time, that our accountants began to conclude that, although there are significant differences in the types of risks assumed by the title industry as opposed to the property/casualty industry, perhaps we should not treat our losses any differently than property/casualty companies treat theirs. And a new monster was born, given the name of incurred but not reported losses or IBNR.

Mr. Jensen chairs the ALTA Research Committee and is executive vice president, administration for Chicago Title Insurance Co., Chicago. He presented this paper at the ALTA Mid-Winter Conference in Hot Springs, Va.

"The eggs of a service called Construction Disbursement Guarantees hatched and gave birth not to cute little chicks, but rather to dragons."

The theory behind IBNR is relatively simple and, in fact, reasonable. It is both known and accepted that claims can arise at almost any time following the writing of a policy. They can arise at the moment we hand the policy to our insured or, sometimes, years afterwards when the property is being transferred or further encumbered. The accounting theory urges that all of the claims that will arise in the future from policies written in a particular year—incurred but not reported—should be provided for and charged against that year's income.

The pressing of this theory by public accountants upon their client title insurance firms created culture shock for many of us. No longer acceptable was the historic methodology of totally relying on the relationship of losses and known claims to current year's revenue, regardless of what year the policy was written upon which the claim is based.

Given the increase in loss ratios, old methodologies were creaking and falling apart anyhow. So, working with our accountants, many of us embraced this new philosophy and attempted to develop methods of forecasting our IBNR.

Unfortunately, there were, and still are, at least two major problems in successfully accomplishing this task. First, many of us did not have sufficient information, either current or historic, concerning the policy year upon which a current claim was based. In addition, the whole idea of IBNR was new not only to the title insurance industry but, in its application to our industry, it was new to our public accountants. We were all at the very beginning of a learning curve and this sometimes led to bizarre results.

"The timing and size of claims, in aggregate and for a policy year, may well be forecastable with a high degree of statistical confidence."

In one case, the auditors of a particular company recommended that the company provide $10 million as a charge against earnings for its anticipated loss experience for one specific policy year. When cross-examined as to the degree of confidence the accountants had in the $10 million figure, it was indicated that they believed it was accurate plus or minus $12 million. Recommendations of this kind are not particularly useful to management.

Currently, the title insurance industry is still grappling with the problem of finding a way to apply what is a reasonable and logical theory to our industry and our specific companies.

The ALTA Research Committee has recognized this as an industry problem for the past several years. Over the last nine months, a special Research Committee task force has been trying to determine what help, if any, the committee can provide to title insurance underwriters.

As a result of our analysis, we believe that the aggregation of proper policy year claims information on an industry-wide basis will ultimately provide a major useful tool to individual companies in two ways. First, it will provide a data base against which an individual company can analyze its own policy year claims and loss information and determine what is an appropriate individual methodology in determining its own IBNR. Secondly, and even more importantly, tremendously useful management information can be provided which will enable individual companies to evaluate and change, where appropriate, matters such as specific underwriting policies, coverage and endorsement language, activities within specific jurisdictions involving offices and/or agents and the functioning of their claims-handling apparatus.

Unfortunately, the development of what we believe is a necessary data base is likely to be both time-consuming and costly. The amount of information which must be captured on each individual claim and then aggregated and manipulated, even for an individual company, is so great that it is impractical to attempt this type of data manipulation without the use of an automated claims system. The complexity rises, in part, because our understanding of IBNR is so limited that no one—either inside or outside the industry—can today say which are the critical data elements.

(continued on page 9)

IBNR—*(from page 7)*

Given today's economic climate, we are not prepared to recommend crash programs in such data collection by individual firms nor, obviously, could we recommend that ALTA attempt to collect and process such data. At the same time, it is important for the industry to know just what we view as the critical elements. As economic conditions permit, we urge the serious consideration of developing an automated system which will both capture and manipulate these data elements.

Essential Elements

In our view, the essential elements which should be maintained by each company on each claim it processes are:

• The policy year, that is, the year in which the policy or commitment was issued—clearly the newest factor in evaluating a policy year's loss experience for predicting IBNR

• The type of claim. In the best of all possible worlds, the ALTA claim categories could be used. At the very least, we urge the use of general categories such as basic policy risks, special risks, plant searching and abstract procedures, examination and opinion errors, closing or escrow procedures, taxes and special assessments, etc.

"We believe that the aggregation of proper policy year claims information on an industry-wide basis will ultimately provide a major useful tool to individual companies in two ways."

• The size of original policy or commitment. This could be kept on an individual basis although analysis would probably be by policy size groupings—for example, policies in the face amount of under \$100,000; \$100,000 to \$500,000; \$500,000 to \$1 million or over \$1 million.

• The year in which the claim was first recognized. This is information most companies historically have kept.

• The location by state or perhaps even by county of the property involving the claim.

• The type of property. New or resale residential, commercial, industrial and vacant, are examples of what we have in mind in this area.

• The size of the loss—either your claims department estimate or actual payments, including the cost of outside counsel. This item would, of course, periodically be modified to reflect actual payments and changes in your loss estimate. In analysis, this data also would be grouped—say, under \$10,000; \$10,000 to \$100,000; \$100,000 to \$500,000; over \$500,000, for example.

• Finally, it may be desirable—although we do not think it is critical—to determine whether the policy was issued by a branch office or by an agent.

Each of these data elements would have to be aggregated in various groupings and related then to some policy year event such as premiums written, face amount of insurance or number of policies issued.

It is the conventional wisdom in the title insurance industry that the timing and size of claim occurrence are totally random events. We have always accepted the fact that claims will arise but *when*, following the issuance of the policy, and *what our actual losses will be*, following the issuance of the policy, have been considered basically unknowable.

Very preliminary conclusions reached by some analysts of title insurance data—based on limited data—give an indication that perhaps the conventional wisdom is in error. The timing and size of claims, in aggregate for a policy year, may well be both knowable and forecastable with a high degree of statistical confidence. If these preliminary indications continue to hold after more companies find it economically feasible to make actuarial analyses of their data, both my committee and I foresee significant changes in the way title companies do business—changes that go way beyond converting Important But Not Resolved to Incurred But Not Reported.

Pioneer Title Acquires Texas Stock

Pioneer National Title Insurance Co. (PNTI) has acquired all outstanding stock of Service Title Co. in Lubbock, Texas.

Service Title was founded in Lubbock in 1951. It has been underwritten by PNTI for the last 14 years.

Gerald L. Ippel, president of PNTI, said the acquisition "is part of PNTI's overall plan to establish a greater presence in the state of Texas."

THE TITLE READER

HOW TO FORM AND OPERATE AN ASSOCIATION CAPTIVE INSURANCE COMPANY

By John J. Matternas and George D. Webster. 97 pages, $40 (soft-cover), published by the American Society of Association Executives, 1575 Eye St., N.W., Washington, D.C. 20005

***—Reviewed by Maxine Stough, Editor,* Title News**

Observers of the insurance industry predict that the decade of the 1980s will be characterized by a shortage of insurance markets or the unavailability of certain kinds of insurance. If such a market constriction indeed occurs, it is not certain whether it will affect title abstracter-agents. The prediction is, however, bound to make them wonder if the errors and omissions liability insurance problems that plagued their businesses in the 1970s will return to dog them in the 1980s. This prospect, following on the heels of the housing bust of the last few years, is not a pleasant one.

How to Form and Operate an Association Captive Insurance Company should be required reading for abstracter-agents—or for that matter, for members of any industry which has ever been caught short by high insurance premiums or unavailability of professional or product liability coverage.

Co-author John J. Matternas said that he expects the 1980s to be "the golden age of association captives." If his prophecy holds, his book will be useful to a number of associations for he and lawyer George D. Webster have compiled a veritable encyclopedia on how to set up and operate an offshore captive insurance company.

Between the covers of this single book, the authors offer up a sumptuous banquet of their years of specialized experience in association law and captive insurance companies. Webster, who is general counsel for the book's publisher, the American Society of Association Executives, is an expert on association law and a founding partner of the Washington, D.C., law firm of Webster & Chamberlain. Matternas is founder and chairman of Insurance Management, a family of companies headquartered in Chevy Chase, Md., with offices in Bermuda and elsewhere.

While a captive can be established in any state so long as it meets the regulatory requirements of that state, the regulations can be so onerous as to constitute a prohibition. Among negatives that the authors cite regarding domestic arrangements are high capitalization requirements, regulation of investment placement and cost of filing the required annual insurance company statements.

From the first chapter, which outlines the benefits of captive insurance companies, it is abundantly clear that the primary mission of the authors is to objectively provide information to enable their readers to begin intelligent thought and research into the advisability and feasibility of a captive.

Although many offshore locations have been used as the site for captives, the authors clearly favor Bermuda and write the book from a Bermuda perspective. In fact, the entire second chapter is devoted to a discussion of the Bermuda Insurance Act of 1978, the text of which is contained in Appendix I of the book.

According to Webster and Matternas, one in 20 of the 1,000 captives in Bermuda are association captives. The main lines of insurance that they provide are professional and liability insurance. This notwithstanding, the authors hasten to caution that a captive is not necessarily for every association. They maintain that there is no reason to consider a captive when a viable insurance market at a reasonable price is available from a U.S. insurance company.

Early in the book, they point out both advantages and disadvantages associated with establishing an association captive. Positive aspects they cite are increased stability, reduced costs and investment and tax advantages. Negatives include the possible difficulty that can be encountered in obtaining and keeping the widespread member support which is so essential to the success of a captive. Another disadvantage is that the task of bringing members of varying sizes and needs together in a consensus may be a difficult, if not impossible, one.

A mechanism which should assist in assessing both advantages and disadvantages and help in determining the advisability of making such a bold move is a captive feasibility study. The underwriting data that the study will yield also will help determine whether or not the group can come up with the ratio of $1 in assets to every $5 of premium to be written that the book reports is required in Bermuda.

The authors estimate that the fee for a feasibility study can range from $5,000 to $50,000 depending on the complexity of the situation. They also point out that the study can be conducted by association staff in cooperation with an accounting firm.

Other needs of an association captive that Webster and Matternas address include counterinsurance, or "fronting;" reinsurance, and investment. The book defines "fronting" to be when a captive uses the services and filing capabilities of an admitted U.S. insurance company. They recommend it for the greater percentage of captives representing an association or industry group and report that "fronting" charges range from five to 15 percent of the captive's annual premiums.

The daily operations and necessary filings with government are handled for a captive by a management company. Duties of the management company and discussion of capitalization requirements, loss funds in escrow and aggregate reinsurance protection are all covered in the third chapter.

Because certain tax advantages are associated with establishing a captive offshore, much is written about the U.S. tax aspects of Bermuda captives. Chapter Four looks at some of the tax problems a captive could confront and offers tips on how to avoid these troubles. This chapter also discusses the kinds of coverage a captive can provide and the reserves it might need.

According to Webster and Matternas, selling stock in the captive is the preferred way to accumulate initial capital. This, then, brings up the complex body of laws that applies to securities activities. To help negotiate this thorny thicket, they stress the importance of consulting with specialists on securities laws if this method of raising capital is to be used.

They note that it has not been decided whether or not U.S. courts view capitalization of an offshore company by members of an association in the same light as public offering of securities. They discuss this question in the final chapter, along with the Securities Act of 1933 which requires drafting a registration statement to be filed with the Securities and Exchange Commission.

They estimate that the expense connected with drafting the full registration statement can run anywhere from $50,000 to $100,000. As an alternative, captive organizers can prepare a Rule 146 circular which they estimate to cost one-half as

(continued on page 19)

Association Captives—A Closer Look

"From the standpoint of the association owning the captive, it's a good member service. A captive provides a means of making insurance available when it may not be so readily available with a stability of market and pricing for its members. Furthermore, it can make a profit which could be rather substantial to the association."

Note: Following is Editor Maxine Stough's interview with John J. Matternas who is a co-author of *How to Form and Operate an Association Captive Insurance Company*. The questions resulted from reading his book which is reviewed on the opposite page. His answers should be of particular interest to abstracter-agents as well as officers of the association.

Mr. Matternas, who has worked in the insurance business since graduating from Pennsylvania State University in 1948, has become a leading authority on association insurance programs. Thirteen years after entering the insurance field, he founded Insurance Management (IM) in Ardmore, Pa. Now, almost two decades later, IM is a family of companies headquartered in Chevy Chase, Md., with offices in Bermuda and elsewhere.

Mr. Matternas, in your book, you predict a shortage of insurance markets or the unavailability of certain kinds of insurance during the 1980s. What market forces do you anticipate will cause such a shortage and/or unavailability?

There are several factors. Probably one of the most important will be a tightening of the worldwide reinsurance market. Peter Green who is chairman of Lloyd's of London, was interviewed recently by *Forbes* and he spells out just how difficult he expects the reinsurance picture to become.

Too many people have jumped into the reinsurance market in the last several years. As a result, to their own detriment, reinsurers have become too competitive. Consequently, they're losing money. There are approximately 60 companies

"There are approximately 60 companies listed as primary sources of reinsurance in the worldwide market. Out of that number, only four are reporting a loss ratio under 100 percent for the 1980 year."

listed as primary sources of reinsurance in the worldwide market. Out of that number, only four are reporting a loss ratio under 100 percent for the 1980 year.

So, you see, as reinsurers lose money, they tighten up their underwriting and are compelled to raise the price of reinsurance. This, together with other factors, is what will precipitate shortages in the standard insurance market.

If you add this changing reinsurance picture together with the fact that we're overdue for some major catastrophes, the handwriting on the wall becomes even clearer. In recent years, there have been no real catastrophic losses. We have had a relatively mild period with no hurricanes hitting the east coast and no major flooding throughout the United States. Other than the fire at the MGM Grand Hotel in Las Vegas, there have been no catastrophic property losses in fire insurance. There have been no air tragedies of the magnitude of the crash at Tenerife in the Canary Islands for several years. This relatively tragedy-free period can't last. The reinsurers know that the law of averages has to catch up with them.

Also, the very rapid rate of inflation that we've had plays an important role. Losses that occurred three and four years ago that are now being litigated will be settled for a lot more money than anticipated at the time of the loss. As these higher losses flow into the marketplace, insurance companies are going to sustain more severe underwriting losses.

Insurance companies have not been making money from an underwriting standpoint recently. They have been making money on the basis of the large volume of premium dollars that they have for investment and the high rates of interest. We cannot hope to continue with the high rates of interest we have had over the last several years. So, as the rates of interest decline, the investment portfolio income of the insurance companies will drop and they will suffer some heavy losses.

Finally, we have been through a period of widespread price-cutting in the standard insurance market. Prices right now are ridiculously too low. Put this together with inflation, a reduction in investment income, an increase in reinsurance costs and reinsurers that are going to become more particular, you will see a shortage of insurance markets and unavailability of certain kinds of insurance coming very rapidly.

This will probably catch in mid-1982. The companies are going to begin to see losses soon. But until they see the year-end results for 1981, they won't tighten up too much. It is true that we see a little stiffening of the market right now but we also see some companies quoting some ridiculously low prices, too.

In predicting this insurance market constriction, you specifically name "social insurance such as workers' compensation." Would you expect professional liability insurance also to be affected?

Unequivocally so. The loss results in professional liability insurance of all types are terrible. You can see this when you look at the continuing losses in medical malpractice and errors and omissions coverage for engineers and architects.

One reason is because the backlog in the courts of professional liability cases is starting to catch up. There will be an increase of judgments in 1981-1984 that are the result of this backlog that occurred as society became more litigious in the 1970s.

These claims will carry judgments much higher as a result of inflation. These larger judgments will affect the primary insurance market and, because of the layoff procedures of the primary insurer into the reinsurer, it will also affect the reinsurance market.

Peter Green of Lloyd's predicts that at least one reinsurer will go broke during this period. If such a failure occurs, the reinsurance market will be squeezed even more tightly.

You say that an association should not consider forming a captive if its members can obtain coverage at affordable prices. Is there some measure or rule that can be applied, on an industry level, to determine what is "affordable"?

The rule of thumb is simple. If your members can buy insurance through a regular United States insurance company in which the rate level justifies the losses that are occurring with just a reasonable profit for the insurance company, then that's an affordable situation. There wouldn't be enough difference between what a captive insurance company can do, assuming the same dollars in losses, to justify the start-up costs of the captive.

A "reasonable" profit would be the same as for any other major industry in the United States. Generally speaking, if Ford or General Motors makes three or four percent profit, we think that's reasonable. The insurance industry is willing, for the most part, to operate on a profit substantially less—around one to 1.5 percent. They can't justify less of a profit to their stockholders if they are a stock company, owned by the public.

They certainly cannot justify less than that if they're a mutual company simply because they have to retain enough liquidity and increase their surplus in order to justify continuing to write larger volumes of insurance.

With continuing high rates of inflation and the attendant upward spiral of, for example, property values, insurance companies have to make sufficient profits to increase their surplus so that they can write larger volumes of insurance. And the larger volumes are dictated by just that—inflation.

Your book reports that associations which have formed captives have experienced substantial membership growth. Were these primarily manufacturing associations whose members faced difficulties with their product liability coverage or were some of them professional associations whose members needed malpractice or errors and omissions insurance?

Relatively speaking, a small percentage of professional associations have gone to Bermuda or the Cayman Islands to form captives to provide cover for their professional liability insurance. Most of the captive formation has been for the construction industry because it suffered the greatest incidence of rates which were not justified by the loss levels its members experienced.

Another area that experienced panic-pricing was product liability. The entire United States insurance industry became very scared of product liability when it saw what started happening in the mid-1970s. Although the insurance industry had no statistics at the time, product liability rates were increased substantially for some manufacturing risks. In other cases, product liability coverage was totally unavailable. So these firms, often took the captive route in order to solve their problems.

In the last two years or so, we have seen some rate reduction which indicates that after a period of time, insurance companies realized that they had increased their rates beyond what was necessary at the time.

So you see, costs that drove single corporate accounts to captives increased very substantially in the mid-1970s. An account that I'm familiar with was paying approximately $300,000 a year in premiums. Suddenly in 1976, it faced a renewal price from a United States insurance carrier of $1.2 million.

Many insurance companies also lost their standing with Best's Insurance Ratings in the mid-1970s. It was during this time that we saw some major companies with topnotch Best's ratings suddenly drop in their standing. Their ratio of surplus to premium writings began to get out of line. The United States insurance industry has generally considered a safe ratio to be three or four to one surplus to premium. Some of the major companies went to a ratio of eight, nine and 12 to one of surplus to premium writings. This could happen again.

From the standpoint of generating upfront, immediate capitalization, you unequivocally state that a stock captive is far superior to a mutual arrangement. You also note that the stock may be owned by the association, by the members or both. Generally, what are the advantages and disadvantages of each of these ownership possibilities?

"It's important to look carefully at what's practical. You could get into a line of insurance that may not generate sufficient premium volume, but could generate a large loss. In a case such as this, you could hurt the captive by putting that particular line of insurance into it."

From the standpoint of the association owning the captive, it's a good member service. A captive provides a means of making insurance available when it may not be so readily available with a stability of market and pricing for its members. Furthermore, it can make a profit which could be rather substantial to the association. And, currently, under the rules for a non-profit corporation, the association can absorb those profits tax-free.

There are disadvantages, too. The association would have to watch carefully for the possibility that the Internal Revenue Service might change its mind with respect to this tax-free status.

If the association doesn't have the start-up capital itself the question then becomes whether or not the association can obtain the funding from its members without finding itself in a situation where the members who provide the capital look for favored treatment.

In the case of member-owned captives, the most obvious advantage is that it is an investment from which they can realize a healthy profit. But because so many of us are avaricious, there is always the possibility that the members who own the captive could get into stockholder fights for its control. Or some may get off on a tangent to make personal profit at the expense of serving the membership at large. When this happens, the captive begins to fail to serve the purpose for which it was established—to serve its members.

If the members and association go into partnership, the association should really retain the control of the captive so that a certain group of members couldn't just wrest control of it.

Which option is chosen should depend upon the needs of the particular group. You can never say that any single solution is the best in all situations. Each one of them has to be looked at on its own and measured against the special needs of a particular group.

Although you clearly favor the stock form for an association captive, what arguments could be made in support of a mutual formation?

Probably the biggest argument—and the only one as far as I can see—in support of a mutual is that you do not have to raise stock subscriptions in order to capitalize.

However, there are some arguments against mutuals that have to be considered. The first is speed. It is very slow to form a mutual company. It takes much more time than to form a stock company. Also, because of their stability and financial capability, stock companies generally are more acceptable to reinsurers than a mutual company. In getting started, the mutual company really only has as capital the first year's premium and what it builds in surplus over a period of time that is profit after losses are paid.

You call reinsurance "the backbone of the captive's day-to-day operations" and explain it as an insurance company (the captive) buying insurance. What is the likelihood that a market phenomenon might develop which would act in such a way as to drive the price of the captive's reinsurance to prohibitively high levels, effectively breaking the captive's back?

It is likely in some cases. I would foresee that with the current problems in the reinsurance marketplace that I described earlier, some captives are going to have to raise prices substantially. But the secret to weathering reinsurance problems like that will lie in management of the captive. For example, you can't just go to Bermuda, form your captive insurance company and run it from here. The law says that you must employ a manager for your captive insurance company who is headquartered in Bermuda.

Now, you have to carefully evaluate the capabilities of your manager as well as his track record in producing profits for other captives that he's already managing. You also look at his ability to place reinsurance and his reputation with the reinsurers.

Captives that use management companies with what we call "in-house facilities" are in the best positions. These types of management companies are able to lead with the reinsurance and establish a pricing to secure reinsurance beyond that. Those are the management companies generally with better track records and the other reinsurers are willing to follow that lead.

So in the face of possible high levels of reinsurance pricing, these factors will be what maintain certain captives in a better position than others.

By the time an association has funded a feasibility study, filed the costly registration statement or a Rule 146 circular with the Securities and Exchange Commission in order to sell stock and obtained the necessary fronting arrangement and reinsurance, hasn't it come close to the point of diminishing returns?

No, it won't even come close to that point. Most of these things—the feasibility study, the registration statement or the Rule 146 with SEC in order to sell stock—are all one-time costs. So, a captive won't need to write all of that off in its first year of business. In fact, those costs generally are written off over a period of three to five years. On this basis, the average captive would write off these costs at $10,000-15,000 a year.

The fronting arrangement and reinsurance, of course, are annual costs. Reinsurance, if it is a problem, is a problem of increased costs. The fronting arrangement is not a problem. Where just a few years ago fronting was difficult to obtain for associations, we are finding it more and more available all the time. The reason is simple. Association captives are being seen as the big movement of the 1980s in the insurance industry—probably the biggest single movement that will have an effect on the insurance industry worldwide. They want to get their piece of the pie so fronting prices are going down and arrangements are much more available.

You define the "rent-a-captive" option as the policy-holders' use of an insurance facility and risk-bearing structure which they do not own or control. From your description, such an arrangement constitutes a trade-off between the benefit of avoiding formation and capitalization of their own insurance subsidiary and the disadvantage of forfeiting control. With this in mind, what factors would make it advisable for an association to opt for the "rent-a-captive" solution over forming its own?

The first, and singularly most important factor is speed. If members of an industry or association need a captive in a hurry because they're having an immediate problem and can't wait nine months to a year for a feasibility study and the time it will take to find adequate sources of capital, rent-a-captive as a starter is a good solution.

It can act as an interim cover until they get their own captive up and going. In fact, at present, we are renting our own captive to an association. Over a period of time, as we develop funds from their group's premiums, it will give them the ability to raise the capital and at that point form their own captive, thus making the transition from our captive to their own in a very orderly process.

Some associations, in fact, could carry the rent-a-captive option indefinitely. There are cases where members of a particular association clearly need a captive but the premium volume that they can generate would not justify their own captive.

To justify a trade association captive, members should be able to generate premiums in excess of $1 million a year and preferably more than that. Take, for example, a trade association that might only generate say $600,000-800,000 in premiums. It may be underwritable, but it's not very practical from the standpoint of the overall annual premium volume size for them to form their own captive. The rent-a-captive option, then, is practical and, indeed, advantageous in some of those cases. The rent-a-captive option gives them the means to achieve what they couldn't any other way.

One of your problems, of course, in a captive is the difficulty of raising funds. We know of several associations which had to stretch very, very far in order to raise adequate funds to meet the capitali-

"Some studies don't consider the fact that some of the information that they receive is spurious. It may be spurious because an insurance agent or broker gave the wrong information. Or, it may be inaccurate because the person who's reporting it is a noninsurance person and doesn't know how to report it accurately."

zation requirements. While it is true that capital requirements in some areas are not as high as in Bermuda, it is becoming evident that these jurisdictions generally begin to follow what Bermuda does. As the book points out, Bermuda's new law requires that for the first \$6 million in premium, a ratio of premium writings to capital of five to one must be maintained.

So, if you have \$1 million in capital, you can write \$5 million in premiums. This requirement holds up until \$6 million. Once you cross the \$6 million dollar mark, you can then go to a ratio of 10 to one on the premiums in excess of \$6 million. So when a captive obtains the first \$6 million in premiums, it needs \$1.25 million in capital. After that, assume that it writes another \$6 million. It's still going to need another \$600,000 of capital. So for a \$12 million premium captive in Bermuda, we're going to need \$1,850,000 in capital.

And, of course, the captive manager is charged, along with the accounting firm that certifies the captive's statement, to report to the Bermuda minister of finance. When there is inadequate capital, you receive a notice about the captive's solvency. Then, you either reduce your premium writings or increase your capital. The rent-a-captive situation can resolve all of this because it's the problem of the rentor to provide the capital in adequate amounts to meet the solvency requirements. It makes it simpler for some associations.

In your discussion of feasibility studies that associations use to explore the captive concept, you say that answering the underwriting questionnaire often is a tedious process and that respondents must enlist the help of their brokers and current insurers in order to provide accurate information.

Other authors writing about captive feasibility studies report that respondents are reluctant to honestly discuss loss experience and therefore may "fudge" the answers. Another factor that could impact upon the credibility of such underwriting information is that brokers and insurers may be less than fully cooperative in helping the respondent answer the questionnaire since a captive, if formed, would take business away from them.

How legitimate do you think that these points are? If they threaten the accuracy of the feasibility study, would you recommend trying to compensate for an inaccurate data variable?

These points are legitimate and they deserve consideration. The quality of the feasibility study is extremely important. Consequently, the capability of the people who will perform the feasibility study has to be taken into account.

A good feasibility study allows some compensating factors for the things that you're bringing up. They are built into the study. Not everybody knows the proper factors for compensation, nor do they include them.

Some studies don't consider the fact that some of the information that they receive is spurious. It may be spurious because an insurance agent or broker gave the wrong information. Or, it may be inaccurate because the person who's reporting it is a noninsurance person and doesn't know how to report it accurately.

A feasibility study has to include a large enough group of people. The whole concept of insurance is based on the theory of the law of large numbers. A feasibility study has to have large enough numbers as well so that some of the inaccuracies are compensated for.

Some feasibility studies don't adequately take into account continuing inflation rates, for example. You can't take losses of five years ago and include them for the dollars that they were worth five years ago. If 1977 losses will be settled and paid in 1982, you're going to have to use progression, as we call it, to factor in the inflation from 1977 to 1982 when the claim will be paid.

A good feasibility study finds the errors. In the case of errors in a study, you go out specifically with direct questions by personal contact in order to correct most of them.

It is true that some agents and brokers will oppose the formation of a captive because they won't want to accept the lower rate of commission. About 25 years ago, commissions on homeowner's insurance were 25 percent. They were 20 percent on personal automobile insurance. When insurance companies started to bill the customer directly, they reduced the percentage of the agent's commission.

The agents fought direct bill fiercely. They criticized it for taking away their control. And they said it would eliminate the agent's relationship with the customer and that the policyholder would no longer get proper advice on his insurance. It all proved to be patently false.

The less modern-thinking agents will resist the captive movement the same way

(continued on page 19)

by Barbara J. Grady

Legislation Proposed to Settle Boundary Flap

Thousands of boundary and title disputes between the U.S. Forest Service and private landowners may be on the road to resolution with legislative proposals recently introduced in the U.S. Senate. The disputes have arisen during the past few years as the Forest Service resurveys national forest boundaries.

Last month, Sen. Pete Domenici (R-N.M.) introduced two bills to resolve the boundary problems, S. 705 and S. 706. One would allow the exchange or sale of specified lands between the U.S. Forest Service and private landowners as a means of settling title and ownership disputes. Exchangeable federal lands would be those unknowingly encroached upon by improvements, lands adjacent to mineral patents and road rights-of-way no longer needed by the federal government. The second bill, S. 706, would declare a national policy of quick performance, approval and notice of federal land surveys. It also would encourage the involvement of landowners and states in the surveying of federal lands and initiate a study on the feasibility of a national multipurpose land information system.

"The problem at issue has resulted in loss of assets, and the clouding of titles of privately owned land, which had previously perfected titles," Sen. Domenici said in his floor speech with specific reference to the New Mexico problems.

"Clearing these titles now involves waiting until all federal land resurveying and subdividing is completed and certified.... In the meantime, no one can sell or exchange property with an insured title," he said.

Jim Hughes, legislative assistant to Sen. Domenici, said he expects the proposals will face little controversy. They are designed to resolve problems nationwide "rather than Congress passing many single relief measures to answer needs of individual problems," Hughes said. Another reason why little opposition is expected is that the provisions of S. 705 "call for very little tax expenditure," according to Hughes.

George Ramonas, legislative coordinator in Sen. Domenici's office, predicts hearings on the bills in early summer, with full Senate consideration possible in September.

According to Ramonas, S. 705 was referred to the Senate Committee on Agriculture, Nutrition and Forestry and S. 706 was referred to the Public Lands and Reserved Water Subcommittee within the Senate Committee on Energy and Natural Resources.

S. 705 would empower the secretary of agriculture, the cabinet member with jurisdiction over the Forest Service, to sell or exchange by quitclaim deed all title, interests and rights of the United States in and to national forests lands which are of three descriptions. Such lands, as described in the bill, are parcels of up to

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10 acres encroached upon by improvements made by people who in good faith relied upon an erroneous federal survey, title search or other land description which indicated they owned the land and who improved the land prior to notice of the encroachment.

Secondly, they may be parcels of up to 40 acres which are interspersed with or adjacent to mineral patents and which have a fair market value of not more than $150,000. And, thirdly, the lands may be parcels which are federally owned road rights-of-way, the exchange or sale of which will be subject to first right of abutting landowners.

The Forest Service, through the secretary of agriculture, may accept as exchange for national forest lands "other lands, interests in lands, or cash payments, or any combination of such forms of consideration, equal in value to the fair market value of the lands sold or exchanged" by the Forest Service.

S. 705 stipulates that the parties to whom federal lands are conveyed through this act will be responsible for whatever costs of administration, survey and appraisal may result from the conveyance. Hughes said this provision is included to scotch notions that the bill allows a "federal lands give away."

The bill is very similar to S. 160 introduced by Sen. Harrison Schmitt (R-N.M.) early this year and recently co-sponsored by Sen. Ted Stevens (R-Alaska). The Schmitt bill also authorizes the secretary of agriculture to convey disputed national forest lands to landowners by quitclaim deed, but it does not require that the lands be sold or exchanged. Applicable to parcels of up to five acres, S. 160 would have forest lands conveyed to adjacent landowners without remuneration or trading of land.

The Schmitt bill was referred to the Public Lands and Reserved Water Subcommittee within the Senate Committee on Energy and Natural Resources. No further action has been taken.

Sen. Domenici's second proposal focuses on federal land surveys and promoting a more uniform system of land information records. It proposes that a national policy be established of time frames under which federal surveying must be carried out. It specifies the number of months by which a survey must be completed once initiated, by which a survey must be certified once completed and by which the local public and affected landowners must be notified before a federal land survey is to take place. It also sets a time limit for the placement and marking of survey monuments. If a monument is not certified and recorded within 90 days of a survey's completion, it is to be removed.

Along with rules on time structures, the bill lists the parties to be notified about the intent of undertaking a federal land survey. They include individual claimants, landowners, the local government, the local public and affected federal agencies.

Additional purposes of the bill stated in the text are to promote cooperation of landowners and the states in federal boundary surveying and to promote stability in the nation's survey records. Another purpose of the bill is to direct the departments of Interior and Agriculture to study the feasibility of developing a multipurpose cadastre and the need for such a land information system.

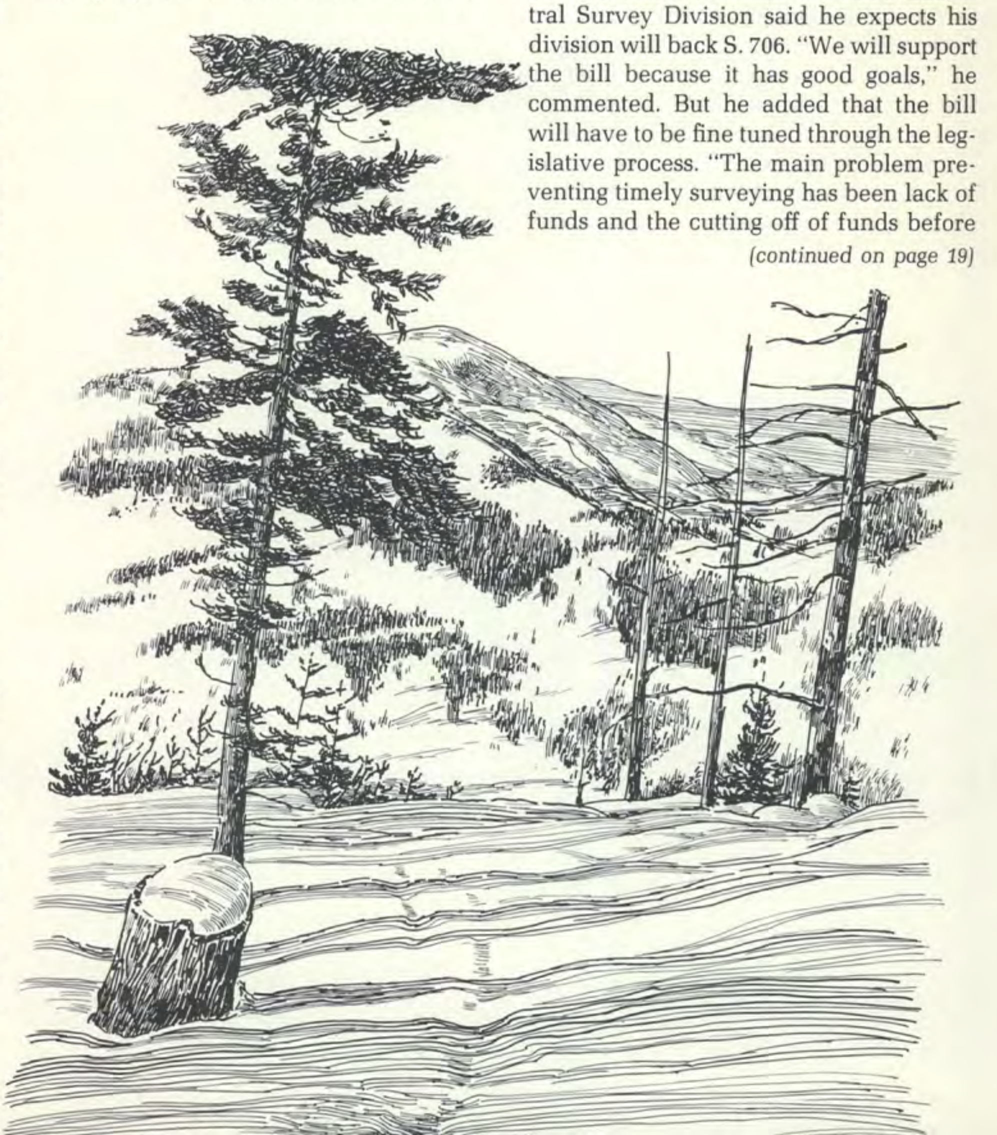
The bill reaffirms what it describes as "continuing national policy" of, among other things, "to protect the bona fide rights of claims of any claimant, entryman, or owner of lands affected by such federal land survey, resurveys or retracements."

Section Four of S. 706 authorizes and directs the secretaries of Interior and Agriculture to "conduct an assessment of multipurpose national cadastre information needs and develop a feasibility study for establishing a multipurpose national cadastral system." These departments are to undertake the study in consultation with state governors and the National Academy of Sciences. S. 706 stipulates that the study is to be completed and submitted to the Senate and House of Representatives within three years after passage of the act.

In advocating a multipurpose land information system, Sen. Domenici told the Senate "over the last 10 years, pressures have been building to modernize cadastral records systems in the United States as needs to cut land transfer costs, to determine landownership and to ease access to all sorts of land information have become more evident." His bill would set up a structure for studying the practicality and possibility of such a land information system in this country, the implementation of which would require further legislative action.

So far, Sen. Domenici's proposals have been welcomed by officials at the Department of Interior's Bureau of Land Management (BLM) Cadastral Survey Division as well as from officials at the U.S. Forest Service. Keith Williams of BLM's Cadastral Survey Division said he expects his division will back S. 706. "We will support the bill because it has good goals," he commented. But he added that the bill will have to be fine tuned through the legislative process. "The main problem preventing timely surveying has been lack of funds and the cutting off of funds before

(continued on page 19)



Names In The News . . .

Kenneth McBride

Richard Bennett

Barbara H. Aiken was named national accounts executive for Title Insurance Company of Minnesota's southeast region. The southeast region consists of Delaware, Florida, Georgia, Maryland, North and South Carolina, part of Tennessee, Virginia and the District of Columbia. Aiken, who works from the Atlanta, Ga., office, coordinates title transactions for national customers based in these states.

Kenneth E. McBride was named president of American First Abstract Co., Norman, Okla. He had been senior vice president and general counsel of American First Title & Trust Co. in Oklahoma City. McBride is a member of the ALTA Judiciary Committee and Legislative Committee.

Richard F. Bennett was promoted to executive vice president and chief operating officer of Chelsea Title and Guaranty Co., Atlantic City, N.J. He is a 30-year veteran of the title industry.

First American Title Insurance Company of New York, White Plains, announced the promotion of **Howard Oken** to vice president and area counsel and **Edward Votta** to vice president and branch manager.

At First American of New York's Garden City, N.Y., office, **Peter Castiglione, David Glick, Thomas J. Lynch** and **Harold Parrott** were promoted to vice presidents.

Also in the Garden City office, **Thomas Aurrichio** was appointed assistant vice president and **Marjorie Scharff** and **Robert T. Fisher** were named assistant title officers.

Patricia Donaldson and **Theresa Felicio** were appointed assistant secretaries in First American of New York's Garden City office.

Chet Burchinal, Jo Ann Turville and **Mark Wanich** have been promoted to national account managers for Title Insurance and Trust Co. (TI), in the national title service organization. As account managers, they assist in the development of new accounts needing title insurance and escrow services on multi-state and multi-county real estate transactions. The market for each is Southern California.

Burchinal, who has been with TI since 1973, is responsible for accounts in the Ventura County and the Thousand Oaks territory. Turville is responsible for clients in the Los Angeles area. She has been with TI since 1972, most recently serving as senior account manager.

Wanich represents new clients in Orange County. He joined the company in October 1980 as major account manager.

Also new at TI is the appointment of **Robert L. Levine** as assistant vice president and sales manager for the Los Angeles district. He is responsible for sales, marketing and information and customer service functions.

Association Captives—*(from page 15)*

that they fought against direct bill 25 years ago.

In our method of operation, we don't cut the broker out. Any broker or agent can bring in an account and he will receive a commission. It is somewhat of a reduced commission. But, then he's not expected to do the work that he was doing prior to that. So his income, in relation to his expense and what he has to provide, is better than ever. He just has to be forward-thinking enough to understand that.

It appears that in certain circumstances you would advocate a captive handling more than one type of insurance. How wide a spectrum of coverages can a captive prudently offer?

A captive can prudently offer anything that is practical. There are enormous economies available for the captive which provides several or many forms of insurance. The captive is already in place. It already is paying certain overhead expenses that don't increase.

Also, as you add more lines of insurance, the cost of reinsurance diminishes to some extent. It tails off so that reinsurance cost for multiline captives per dollar of premium income ends up being less per dollar of insurance than for a monoline captive because of volume. Again, it's the law of large numbers. It means that a reinsurer is covering an insurance company that generates $15-20 million in premium volume versus one that's generating $2 million.

Similarly, when a captive provides its own first $500,000 in protection, and buys insurance thereafter, the first $500,000 of reinsurance is going to be the most expensive. The next $1 million is going to cost a little less. The next $3 million up to $5 million will be less than that and so forth. So, you see buying more reinsurance becomes less expensive per pound, you might say, of premium income that the captive generates.

Now, when I say that the captive can offer anything that's practical, it's important to carefully look at what's practical. You could get into a line of insurance that may not generate sufficient premium volume, but could generate a large loss. In a case such as this, you could hurt the captive by putting that particular line of insurance into it. You have to determine which kinds of insurance to include by the size of the premium volume in relation to loss potential.

Boundary Flap—*(from page 18)*

survey jobs are completed," he explained. S. 706 proposes to establish time frames by which surveys must be completed. If these are to be adhered to, Williams said, Congress will also have to provide for funds and manpower.

Both the BLM Cadastral Survey Division and the U.S. Forest Service have expressed support of the proposal to study the feasibility of a multipurpose national cadastral land information system.

Title Reader—*(from page 10)*

much as preparing a full registration statement. Both alternatives are discussed at length.

In all, Webster and Matternas present a complex topic in an interesting and well-written fashion. In addition to becoming conversant on the topic, the reader occasionally will happen upon interesting facts about captives carefully woven into the material. Among other things, it may surprise him to discover that Lloyd's of London was founded as a mutual pooling device to provide insurance protection for large marine loss.

How to Form and Operate an Association Captive Insurance Company is a good starting place for any industry or profession which may be contemplating an alternative insurance mechanism. And, after having read Webster and Matternas, it is likely that the reader will want to make use of Appendix 2 which lists four pages of additional readings on the topic.

Calendar of Meetings

March 25-27
American Land Title Association
Mid-Winter Conference
The Homestead
Hot Springs, Virginia

April 30-May 2
Arkansas Land Title Association
Lake DeGray Convention Center
Arkadelphia, Arkansas

April 30-May 2
New Mexico Land Title Association
Holiday Inn
Las Cruces, New Mexico

April 30-May 3
North Carolina Land Title Association
Litchfield Inn and Country Club
Litchfield, North Carolina

May 3-5
Iowa Land Title Association
Holiday Inn
Amana, Iowa

May 7-9
Oklahoma Land Title Association
Sheraton Century
Oklahoma City, Oklahoma

May 14-15
California Land Title Association
Islandia Hyatt House
San Diego, California

May 14-16
Texas Land Title Association
Palacio Del Rio Hotel
San Antonio, Texas

May 28-30
Tennessee Land Title Association
May 28-31
Opryland Hotel
Nashville, Tennessee

May 31-June 2
Pennsylvania Land Title Association
Shawnee on the Delaware
Shawnee, Pennsylvania

June 7-9
New Jersey Land Title Insurance Association
Seaview Country Club
Absecon, New Jersey

June 11-14
New England Land Title Association
Sea Crest
Falmouth, Massachusetts

June 22-24
Oregon Land Title Association
Ashland Hills Inn
Ashland, Oregon

June 25-27
Land Title Association of Colorado
Sheraton Steamboat Resort
Steamboat Springs, Colorado

June 25-28
Illinois Land Title Association
Marriott's Lincolnshire
Lincolnshire, Illinois

June 28-30
Michigan Land Title Association
Grand Traverse Hilton
Traverse City, Michigan

July 16-18
Wyoming Land Title Association
Ramada Inn,
Casper, Wyoming

July 30-August 2
Idaho Land Title Association
Shore Lodge
McCall, Idaho

August 6-8
Montana Land Title Association
Sheraton Hotel
Billings, Montana

August 6-9
Utah Land Title Association
Elkhorn Village
Sun Valley, Idaho

August 13-15
Minnesota Land Title Association
Holiday Inn
Grand Rapids, Minnesota

August 14-15
Kansas Land Title Association
Holidome
Dodge City, Kansas

August 20-13
Alaska Land Title Association
Juneau, Alaska

August 30-September 1
Ohio Land Title Association
Hyatt Regency
Columbus, Ohio

September 1-4
New York State Land Title Association
The Otesga
Cooperstown, New York

September 9-12
Washington Land Title Association
Thunderbird Motor Inn
Wenatchee, Washington

September 11-13
Missouri Land Title Association
Lodge of the Four Seasons
Lake Ozark, Missouri

September 13-15
Indiana Land Title Association
Merrillville Holiday Inn
Merrillville, Indiana

September 17-19
North Dakota Land Title Association
Kirkwood Motor Inn
Bismark, North Dakota

September 20-23
American Land Title Association
The Broadmoor
Colorado Springs, Colorado

September 23-25
Nebraska Land Title Association
Holiday Inn
Kearney, Nebraska

October 2-4
South Carolina Land Title Association
Hilton Head Island, South Carolina

October 15-16
Wisconsin Land Title Association
Pioneer Inn of Lake Winnebago
Oshkosh, Wisconsin

November 11-14
Florida Land Title Association
Hotel Royal Plaza
Lake Buena Vista, Florida

American Land Title Association

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