

**STUDY OF INSURANCE COMPANY INSOLVENCIES
FROM 1969-87 TO MEASURE THE EFFECTIVENESS
OF CASUALTY LOSS RESERVE OPINIONS**

*American Academy of Actuaries
Committee on Property Liability
Insurance Financial Reporting*

AMERICAN ACADEMY OF ACTUARIES

September 28, 1990

To: Insurance Commissioners, Directors & Superintendents
Chief Examiners

Re: **Casualty Loss Reserve Opinions**

The American Academy of Actuaries Committee on Property-Liability Insurance Financial Reporting is pleased to enclose a report on its study of insurance company insolvencies from 1969-87, which seeks to measure the effectiveness of casualty loss reserve opinions. The study commenced in August, 1989 and reflects responses received through June, 1990. The committee especially appreciates the work done by the Chief Examiners in each of the states which responded.

We hope that you will find this report both interesting and useful. The report consists of an executive summary and a more detailed summary. As indicated, the Academy recognizes the importance of the casualty loss reserve opinion requirements and plans to perform additional studies on this topic.

We very much appreciate the cooperation that we received in performing this study. If you have any comments or questions about it, please do not hesitate to write me.

Very truly yours,



David G. Hartman, Chairman
AAA Committee on Property-Liability
Insurance Financial Reporting
c/o Chubb Group of Insurance Companies
P. O. Box 1615
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Warren, New Jersey 07061-1615

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Enclosure

AMERICAN ACADEMY OF ACTUARIES

STUDY OF INSURANCE COMPANY INSOLVENCIES FROM 1969-87 TO MEASURE THE EFFECTIVENESS OF CASUALTY LOSS RESERVE OPINIONS

Prepared by the
AMERICAN ACADEMY OF ACTUARIES
COMMITTEE ON PROPERTY LIABILITY INSURANCE
FINANCIAL REPORTING

September, 1990

During the last several years there has been growing concern over the threat of widespread economic distress that could result from insolvencies of U.S. property liability insurance companies. The U.S. Congress, the National Association of Insurance Commissioners (NAIC) and insurance company organizations have all discussed this potentially severe problem and initiated studies to identify actions that will reduce the incidence of insolvencies. In order to contribute to the limited base of information on which to formulate sound public policy decisions, last year the American Academy of Actuaries¹ undertook a study of the effectiveness of current casualty loss reserve opinions. This report presents the results and conclusions to date of the Academy's efforts related to this important issue. The Academy recognizes the importance of loss reserve opinion requirements and plans to perform additional studies on this topic.

¹The American Academy of Actuaries is an organization of professional actuaries in the U.S. which, among other functions, represents the actuarial profession in areas of public issues and discussions involving actuarial concepts. The Academy was founded in 1965 and now has over 10,000 members.

Study Results

This study was conducted by distributing questionnaires to state insurance departments for each of the 153 companies declared insolvent from 1969 through 1987. This report comments on the 105 questionnaires returned.

The highlights of the committee's findings to date are as follows:

- (1) The most commonly cited principle cause of insolvency was "under-reserving". "Under-reserving" was noted in 58% of the insolvencies for which causes were identified. "Mismanagement" was the second most frequently identified cause of insolvency, cited in 41% of the responses. Loss reserve opinions clearly may help reduce the incidence of insolvencies where under-reserving is a potential cause of insolvency. It is less certain that loss reserve opinions can address situations where mismanagement or other factors are the principle cause of insolvency.

- (2) Many of the loss reserve opinions for companies subsequently declared insolvent were qualified or conditioned in some manner (4 of 9 cases studied). Since the committee did not review the specific reasons the opinions were qualified and the causes of the subsequent insolvency, we cannot conclude whether or not the opinions for these nine companies were appropriate.

- (3) In the majority of insolvencies studied, no loss reserve opinion was rendered (81 of 105 cases). Since most of the insolvencies occurred prior to 1981, loss reserve opinions were not required for Annual Statements filed prior to the declaration of most of the insolvencies studied.

Even if the actual statements of reserve opinions do not clearly help regulators to identify potentially troubled companies, there is anecdotal evidence that opinion requirements lead to improved management actions. Loss reserve opinion requirements and professional responsibilities of actuaries tend to create an environment where actuaries have a significant voice in the financial management of an insurance company. In analyzing reserves, an actuary may find inadequate reserves, inappropriate reinsurance programs, inadequate pricing or a number of other problems which can result in impaired financial condition if not addressed. By communicating such findings before problems become too severe, actuaries can help to promote sound financial management of an insurance company and possibly reduce the chance that an insolvency will occur.

Since many insolvencies are caused by mismanagement, fraud and other factors not typically reviewed in an actuarial analysis, strong loss reserve opinion requirements cannot be expected to prevent all

insolvencies. However, the Committee believes that loss reserve opinions by qualified actuaries contribute to the prevention and early detection of insolvencies of property liability insurance companies.

Background on Loss and LAE Reserves and Reserve Opinions

Reserves for losses² and loss adjustment expenses (LAE)³ together represent by far the largest liability on the balance sheets of property liability insurance companies. At year-end 1989, these reserves comprised two-thirds of the industry's total liabilities and were about double industry surplus.

There is usually substantial uncertainty about loss and LAE liabilities since they represent future costs, often many years away. But reasonable estimates of liabilities are needed as part of the sound management of an insurance company. If a company underestimates loss liabilities, its surplus will be overstated and the reported balance sheet may present a severely distorted picture of the financial health of the company.

Given the importance of accurate estimates of loss and LAE liabilities to the financial integrity of property liability insurance companies, the NAIC in 1981 adopted optional guidelines for loss reserve opinions in the NAIC Fire and Casualty Annual Statement. If adopted

²Loss reserves are liabilities for future payments to claimants for insured incidents which have already occurred.

³Loss adjustment expense reserves are liabilities for the future cost of adjusting or settling insured claims which have already occurred.

by a state, these guidelines specified the format for a signed statement of opinion by a "qualified loss reserve specialist".

The NAIC defined a "qualified loss reserve specialist" as a member in good standing of the American Academy of Actuaries, or a person who otherwise had competency in loss reserve evaluation. This definition easily allowed a non-member of the Academy (including non-actuaries such as Certified Public Accountants or company officers) to self-certify their competency.

The NAIC instructions specified that the opinion must contain a paragraph identifying the specialist, a scope paragraph, an opinion paragraph and additional paragraphs if needed to state a qualification of the opinion. The instructions also noted that "the opinion paragraph should include a sentence which covers at least the points listed in the following illustration:"

"In my opinion, the amounts carried in the balance sheet on account of the items identified above

- (i) are computed in accordance with accepted loss reserving standards and are fairly stated in accordance with sound loss reserving principles.
- (ii) are based on factors relevant to policy provisions.
- (iii) meet the requirements of the insurance laws of (state of domicile).

(iv) make a good and sufficient provision for all unpaid loss and loss expense obligations of the Company under the terms of its policies and agreements."

For 1989 Annual Statements, twenty-four states required an actuary or qualified loss reserve specialist to provide an opinion on loss reserves for all or some companies. Since larger insurance companies tend to operate in all or nearly all states and several of the nineteen states required opinions for all licensed companies, loss reserve opinion requirements have applied to virtually all large property liability insurance companies.

In June, 1990 the NAIC took action to strengthen loss reserve opinion requirements. For 1990 and subsequent Annual Statements, a loss reserve opinion is mandatory for all companies except those qualifying for specific exemptions, and the opinion must be provided by a qualified actuary. This action by the NAIC is expected to help reduce the incidence of future insolvencies.

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AMERICAN ACADEMY OF ACTUARIES
COMMITTEE ON
PROPERTY LIABILITY INSURANCE FINANCIAL REPORTING

Responses to Loss Reserve Opinion Questionnaire
Insolvent Companies

In the summer of 1989, the Committee on Property Liability Insurance Financial Reporting (the Committee) of the American Academy of Actuaries (the Academy) began a study of the effectiveness of the current casualty loss reserve opinions.

As part of this project, the Committee requested that chief examiners in the various state insurance departments complete a 12 item questionnaire (Appendix A) for each insurance company declared insolvent from 1969 through 1987.

As of June 18, 1990, questionnaires have been returned for 105 of the 153 companies declared insolvent during this time period. In addition, questionnaires were returned pertaining to four companies that were declared insolvent in 1959, 1962, 1988 and 1989. This report summarizes the results of the 109 questionnaires returned.

The Committee recognizes two constraints within which the study must be conducted. First, there is a limited number of insolvent companies for which loss reserve opinions had been obtained. Second, we are not able to measure the extent to which the requirement for loss reserve opinions may have influenced insurers to avoid insolvencies. Each of these will be discussed in the following paragraphs.

Loss reserve opinions for property/casualty insurance companies were generally not required by state insurance departments until 1981, when the New York Insurance Department began requiring them of all domestic companies. From 1982 through 1989, about 23 other states implemented requirements for loss reserve opinions. In 1990, the National Association of Insurance Commissioners revised the instructions to the Annual Statement to require loss reserve opinions in all states, with limited exceptions.

In the years 1982 through 1987, there were 82 insolvencies; questionnaires were returned in 54 instances. Loss reserve opinions had been required and/or submitted in only 27 of these cases. Because of the relatively small size of the data base, firm inferences can generally not be drawn. However, this study does document the reserve opinions for companies subsequently declared insolvent.

This study is limited to companies that have become insolvent. It does not include identification of insolvencies that were prevented because of the requirement for a loss reserve opinion. In some cases the actuary evaluating the loss reserves may have found reserve inadequacies, thus forcing company management to increase loss reserves in order to obtain an unqualified opinion. In other cases, the actuary may have identified shortcomings, such as inappropriate reinsurance programs, inadequate pricing, improper claims adjustment procedures, and poor underwriting practices that company management was then able to address before these problems resulted in an impaired financial condition. There is anecdotal evidence that suggests insolvencies have been prevented because of the need for a loss reserve opinion, but this is beyond the scope of the Committee's study.

Following is a discussion of each individual question.

- Question 1: Name of insolvent company
- Question 2: Year company declared insolvent
- Question 3: Company's state of domicile

Appendix B displays detailed information regarding questions 1, 2 and 3 for all insolvent companies initially identified in the study. These 153 companies are located in 33 states, Puerto Rico, and the Virgin Islands.

Responses have been received from 24 jurisdictions. These responses pertain to 105 of the 153 companies declared insolvent from 1969 through 1987. Additionally, responses have been received from four companies that became insolvent in 1959, 1962, 1988 and 1989. Among those states from which we have not yet received responses is Texas, in which 11 insolvencies are located.

Exhibit I is a graph of the number of insolvencies, by year, for which we initially solicited responses, and for which responses were received.

In the decade of the 1970's, there were 60 insolvencies. From 1980 through 1987, there were 92 insolvencies.

Question 4: Did the insurance department of the domiciliary state have a loss reserve opinion requirement prior to this company being declared insolvent? (Yes/No)

Detailed information pertaining to this question, as well as to questions 5 through 9, are displayed on Exhibit II. Exhibit II provides information on those companies (24) for which a loss reserve opinion was required, as well as for four companies for which loss reserve opinions were provided although not required.

Of the 24 insolvencies for which loss reserve opinions had been required, all occurred in 1982 or later. As noted previously, loss reserve opinions were not generally required prior to 1982.

During the period 1982 through 1987, there were 82 insolvencies. Information on these insolvencies is summarized as follows:

	<u>Opinion Required</u>	<u>Opinion Not Required</u>	<u>Total</u>
Responses received	24	31	55
Responses not received	<u>3*</u>	<u>24*</u>	<u>27</u>
	27	55	<u><u>82</u></u>

*Based on the Committee's understanding of state regulations in effect at the time of the insolvency

Thus, about one third of the insolvencies occurred in states where a loss reserve opinion was required.

Question 5: Was a loss reserve opinion rendered to any state on this company prior to its being declared insolvent? (Yes - only once/Yes - more than once/No)

As shown on Exhibit II, opinions were rendered for 24 companies, 20 of which were required opinions and 4 of which were submitted although not required.

Question 6: Did the loss reserve opinion use the recommended language verbatim? (Yes/No)

Of the ten responses to this question, six were "yes" and four "no."

The "recommended language" is that contained in the instructions to the Annual Statement." Qualifying statements are commonly added when considered appropriate, although there are currently no guidelines for the use of qualifying statements. As part of its study, the Committee intends to recommend revisions to the "recommended language." These suggested revisions are expected to include qualifying statements intended to alert regulators to various conditions that may increase the likelihood that loss reserves will not be adequate.

Question 7: Was the loss reserve opinion qualified or conditioned in some manner? (Yes/No)

Of the nine responses to this question, four indicated that the opinions were qualified in some manner whereas five indicated the opinion was not qualified.

As previously noted, this Committee intends to recommend standardized qualifying statements.

Question 8: Was the signer of the opinion a (circle letter of each item that applies):

- (a) Member, American Academy of Actuaries (MAAA)
- (b) Fellow, Casualty Actuarial Society (FCAS)
- (c) Associate, Casualty Actuarial Society (ACAS)
- (d) Please specify (e.g. President, Treasurer, Claims Manager, etc.)

We received responses to this question for 20 companies. Using the term "actuary" to mean either a Member of the American Academy of Actuaries or a member of the Casualty Actuarial Society, then 11 of the 20 opinions were signed by actuaries.

For five of these eleven, the response to question 11 indicated that under-reserving was a contributor to the insolvency. For the nine opinions known to have been signed by non-actuaries, only one was apparently associated with under-reserving. This may suggest that companies with loss reserves recognized to be potentially inadequate were more likely to obtain an actuarial opinion.

It was noted in regard to question 7 that four of the opinions were qualified. In all four cases, the signer was an actuary. In only one of these four cases did the response indicate that under-reserving was a cause of the insolvency.

**Question 9: Was the signer an employee of the company?
(Yes/No)**

There were 19 responses to this question. In eleven cases the signer was an employee of the company, and in three of these eleven, an actuary. In eight cases, the signer of the opinion was not an employee of the company, and in seven of these eight, an actuary.

This suggests that when companies obtain a loss reserve opinion from someone outside the company, that person is apt to be an actuary, as defined as a member of the Casualty Actuarial Society or American Academy of Actuaries.

**Question 10: What is the approximate size of this
insolvency? (\$)**

For the 81 companies for whom the size of the insolvency was quantified, the insolvency ranged from \$4,000 to \$1.5 billion (Transit Casualty Insurance Company). Excluding the 20 insolvencies that were for less than \$1 million, the median was approximately \$10 million and the mean was approximately \$55 million. Excluding Transit Casualty, the mean was approximately \$31 million.

During the period 1982 through 1987, there were 39 insolvencies greater than \$1 million for which we received responses as to the size of the insolvency. The mean value was approximately \$80 million.

For those companies for which a loss reserve opinion was required or obtained, the size of the insolvency is shown on Exhibit II.

Question 11: What appears to be the principle cause(s) of this insolvency (e.g., under-reserving, uncollectable reinsurance, fraud, etc.)?

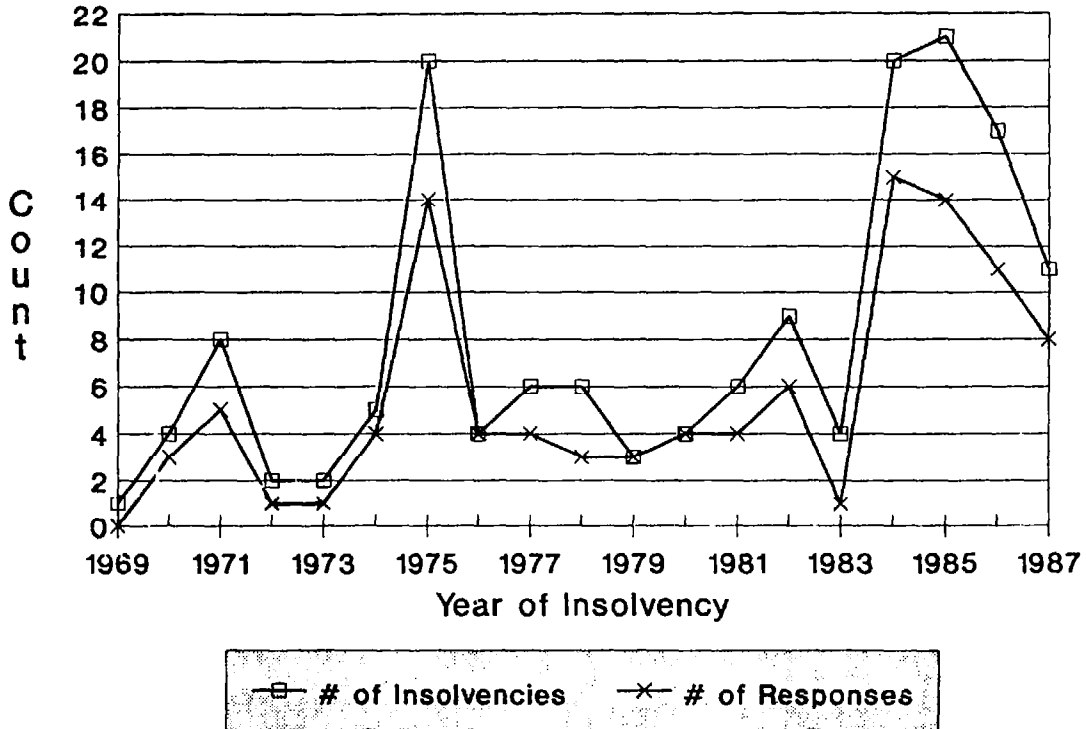
Responses were received for 79 insolvencies. "Under-reserving" was given as the most common response, appearing 46 times as a reason for the insolvency. "Mismanagement" was identified 32 times as a reason. "Poor underwriting," "uncollectable balances," "fraud/theft," "MGA," and "reinsurance" were each identified eight to fifteen times.

For those companies for which a loss reserve opinion was required or obtained, we have shown, on Exhibit I, whether "under-reserving" appeared as a stated reason for the insolvency.

Question 12: What other comments would be helpful for us to have about this insolvency?

Responses to this question were minimal, and they have not been summarized.

Number of Insolvencies/Responses



American Academy of Actuaries
Committee on Property-Liability Insurance Financial Reporting
Loss Reserve Opinion Questionnaire
Insolvent Companies

- 1. Name of Insolvent Company

- 2. Year Company Declared Insolvent

- 3. Company's State of Domicile

Please circle the appropriate answer to each question:

- 4. Did the insurance department of the domiciliary state have a loss reserve opinion requirement prior to this company being declared insolvent?

Yes

No

- 5. Was a loss reserve opinion rendered to any state on this company prior to its being declared insolvent?

Yes - only once Yes - more than once No

If the answer to question 5 was "No", skip to question 10.

If the answer to questions 5 was "Yes", please answer questions 6 through 9 as regards the last opinion rendered prior to the company being declared insolvent.

- 6. Did the loss reserve opinion use the recommended language verbatim?

Yes

No

- 7. Was the loss reserve opinion qualified or conditioned in some manner?

Yes

No

If yes, how?

Loss Reserve Opinion Questionnaire
Insolvent Companies

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8. Was the signer of the opinion a (circle letter of each item that applies):
- a. Member, American Academy of Actuaries (MAAA)
 - b. Fellow, Casualty Actuarial Society (FCAS)
 - c. Associate, Casualty Actuarial Society (ACAS)
 - d. Other (Please specify, e.g., President, Treasurer, Claims Manager, etc.)

9. Was the signer an employee of the company?

Yes

No

10. What is the approximate size of this insolvency?

\$

11. What appears to be the principal cause(s) of this insolvency (e.g., underreserving, uncollectible reinsurance, fraud, etc.)

12. What other comments would be helpful for us to have about this insolvency?

Please print your name

Your telephone number

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Please return by September 30, 1989 to:

David G. Hartman
Chairman, AAA COPLIFR
c/o Chubb Group of Insurance Companies
15 Mountain View Road
P. O. Box 1615
Warren, New Jersey 07061-1615

ASSESSMENTS HAVE BEEN MADE BY THE GUARANTY FUNDS TO COVER THE INSOLVENCIES OF THE FOLLOWING COMPANIES:

<u>Company</u>	<u>Declared Insolvent</u>	<u>Domicile</u>
Key Insurance Exchange	1969	California
Fidelity General Insurance Co.	1970	Illinois
Liberty Universal Insurance		Texas
Ohio Valley Insurance Co.		Ohio
Sutton Mutual Insurance Co.		New Hampshire
Citizens Casualty of New York	1971	New York
First American Insurance Co.		Florida
Homeowners Insurance Co.		Illinois
LaSalle National Insurance Co.		Illinois
Los Angeles Insurance Co.		California
Maine Insurance Co.		Maine
Trans Plains Insurance		Texas
United Bonding Co.		Indiana
Maryland National Insurance Co.	1972	Georgia
Metro Casualty Co.		Missouri
Commercial Underwriters	1973	Michigan
First Fire & Casualty Co. of San Antonio, TX		Texas
Gateway Insurance Co.	1974	Pennsylvania
Granite Mutual Insurance Co.		Pennsylvania
Professional Insurance Co.		New York
Rockland Mutual Insurance Co.		Massachusetts
United American Insurers		Iowa
Associated Merchants Mutual Ins. Co.	1975	Massachusetts
Capitol Mutual Fire Insurance Co.		Pennsylvania
Epic Insurance Co.		Arizona
Financial Fire & Casualty Ins. Co.		Florida
Glaco Automobile Insurance Co.		Montana
Guardian Mutual Insurance Co.		Pennsylvania
Interstate Ins. Co. of W. Collingswood		New Jersey
Manufacturers & Wholesalers Indemnity Exchange		Colorado
Medallion/Missouri General Ins. Co.		Missouri
Mobile County Mutual/Mobile Ins. Co.		Texas
National Mutual Insurance Co.		Michigan
Pennsylvania Taximen's Mutual Ins. Co.		Pennsylvania
Resources Insurance Co. of New York		New York
Satellite Insurance Co.		Pennsylvania
Security Fire & Casualty Insurance Co.		South Carolina
State Security Insurance Co.		Pennsylvania
Summit Insurance Co. of New York		New York

<u>Company</u>	<u>Declared Insolvent</u>	<u>Domicile</u>
Transnational Insurance Co. Westgate - California Wisconsin Surety Co.		California California Wisconsin
Bankers Fire & Casualty Ins. Co. Manchester Insurance & Indemnity Co. Southern American Fire Insurance Co. Woodland Mutual	1976	Florida Ohio Florida Michigan
All-Star Insurance Corporation Builders Insurance Co. Empire Mutual Ins. Co./Allcity Ins. Co. Maryland Indemnity Insurance Co. New York National Insurance Co. Penn State Mutual Insurance Co.	1977	Wisconsin Puerto Rico New York Maryland New York Pennsylvania
Bankers Mutual Insurance Co. Commonwealth Insurance Co. Consolidated Mutual Insurance Co. Consolidated Underwriters Eldorado Insurance Co. Signal/Imperial Insurance Cos.	1978	New York Puerto Rico New York Missouri California California
American Reserve Insurance Co. Long Island Insurance Co. Reserve Insurance Co.	1979	Rhode Island New York Illinois
Atlantic and Gulf States Concord Mutual Insurance Co. Cosmopolitan Insurance Co. State Farmers Insurance Co.	1980	South Carolina Pennsylvania New York Nebraska
Church Layman Mutual Insurance Co. Eastern Insurance Co. Fauquier Mutual Fire Insurance Co. Market Insurance Co. Proprietors Insurance Co. Security Casualty Co.	1981	West Virginia Florida Virginia Illinois Ohio Illinois
Amherst Insurance Co. Cotton Belt Insurance Co. Equitable Insurance Exchange, Inc. Great Indemnity Insurance Co. Kenilworth Insurance Co. Lloyds of America Main Insurance Co.	1982	Pennsylvania Tennessee Texas Puerto Rico Illinois Texas (only) Illinois

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<u>Company</u>	<u>Declared Insolvent</u>	<u>Domicile</u>
Safeguard Mutual Insurance Co.		Pennsylvania
Stuyvesant Mutual Plate Glass Ins. Co.		Pennsylvania
Interco Underwriters Exchange	1983	California
Lincoln Insurance Co. of Puerto Rico		Puerto Rico
Superior Lloyds		Texas (only)
Western Carriers Insurance Exchange		California
Ambassador Insurance Co.	1984	Vermont
Arizona General Insurance Company		Arizona
Aspen Indemnity Corp.		Colorado
Colonial Assurance Co.		Pennsylvania
Dome Insurance Company		Virgin Islands
Excalibur Insurance Co.		Minnesota
Financial Security Insurance Co.		Hawaii
Gibraltar Mutual Ins. Co.		Pennsylvania
Golden West Ins. Exchange		California
Guaranty Insurance Company		Puerto Rico
Gulf American		Florida
Horizon Insurance Company		New York
Ideal Mutual Insurance Company		New York
Independent Indemnity Co.		California
Lawyers Prof. Liability Ins. Co.		Florida
Nassau Insurance Co.		New York (only)
North-West Insurance Company		Oregon
Northeastern Fire Ins. Co. of PA		Pennsylvania
Oklahoma Insurance Logistics Co.		Oklahoma
Universal Casualty Ins. Co.		Florida
American Consumer Insurance Co.	1985	New York
American Fidelity Fire Ins. Co.		New York
Cal-Farm Insurance Co.		California
Columbus Insurance Company		Ohio
Commercial Standard		Texas
Commonwealth Marine		Delaware
Consumers Ins. Group (Kent Ins. Co.)		Florida
Early American		Alabama
Eastern Indemnity		Maryland
Glacier General Assurance Co.		Montana
Guard Casualty & Surety Co.		Indiana
Iowa National Mutual Ins. Co.		Iowa
Pacific American		Delaware
S & H Insurance Co.		California
Southwestern Insurance Co.		Oklahoma
Southwestern National Ins. Co.		Oklahoma
Standard Fire Ins. Co.		Alabama
Temple Mutual Ins. Co.		Pennsylvania
Transit Casualty Co.		Missouri
Union Indemnity		New York
United Employers Ins. Co.		Texas (only)

<u>Company</u>	<u>Declared Insolvent</u>	<u>Domicile</u>
Allied Fidelity	1986	Indiana
American Druggists' Insurance Co.		Ohio
Carrier Casualty Company		New York
Carriers Insurance Company		Iowa
Forestry Industries Ins.		Oregon
Great Global Assurance Company		Arizona
Heritage Insurance Company		Illinois
Intermountain Insurance Company		Montana
Inter-West Insurance Company		Oregon
Lloyds of Louisiana		Louisiana
Merchants & Manufacturers of Cleveland		Ohio
Midland Insurance Company		New York
National Allied Insurance Company		Texas
Optimum Insurance Company		Illinois
Presidio Insurance Company		Indiana
RGAF Underwriters		Florida
Texas Fire and Casualty		Texas
Beacon Insurance Co.	1987	North Carolina
Citizens National Assurance		New Mexico
Enterprise Insurance Co.		California
Holland-America Ins. Co.		Missouri
Homeland Insurance Co.		California
Integrity Insurance Co.		New Jersey
Mission Insurance Co.		California
Mission National Ins. Co.		California
Pine Top Insurance Co.		Illinois
Professional Mutual Ins. Co.		Missouri
Quality Insurance Co.		West Virginia