

July 22nd, 1976

Mr. George D. Young,  
National Indemnity Company,  
3024 Harney Street,  
Omaha, Nebraska. 68131.

Dear George:

Thanks very much for your memo of July 19th regarding GEICO which I believe summarizes well the problems attendant to the specific property treaty we are discussing, as well as the general problems associated with reinsurance of any type at GEICO. I still am willing to explore further the GEICO property treaty - if they subsequently decide that it fits their needs - and today committed to Jack Byrne that we would take a 1% quota share of their entire book. This increase from .8 of 1% was pursuant to his request in order to help him attain the 25% mark by the shareholders meeting tomorrow.

I consider the overall quota share to be an acceptable - but not exciting - piece of business. Under normal conditions we would take nothing like 1%, obviously, since that makes it by far the largest reinsurance treaty on our books, and involves substantial risks along with a limited prospect of profit. I also do not like the feature that provides for a credit to GEICO for interest earnings on funds held by us. In effect, we are making this contract number one in size for the reinsurance department, whereas the contractual terms make it less attractive than most of our other contracts.

However, I have three reasons for taking this unusually large portion of the quota share arrangement, and these same reasons also apply to my interest in the property treaty.

1. I hope it is not a governing factor in any way, but I do have some sentimental reasons for wishing GEICO to survive. GEICO has enumerated all of the hard headed reasons, such as the State Financial Guaranty funds, etc. I just have

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pulled out of the bottom drawer of my desk a statement of my net worth at the end of 1951 when I was 21 years old. I showed net assets of \$19,737, of which \$13,125 was in GEICO stock. That was the year when I first started selling securities, and I told everyone who would listen to me that they should put every cent they could scrape together into GEICO. A number of friends and relatives did so, and enjoyed a significant change in their financial fortunes because of this. It provided the first big boost to my own small savings, as well as an even more important boost to my reputation in the Omaha investment community.

During those early years, when I followed the company, the people involved couldn't have been nicer. Leo Goodwin was running things then and was helpful. Even moreso was L. A. Davidson. He was personally encouraging and forthcoming with information regarding the business, which enabled me to develop a depth of conviction which I have felt few times since about any security.

2. At that time I felt that GEICO possessed an extraordinary business advantage in a very large industry that was going to continue to grow. Since that time they never have lost that advantage - the ability to give the policyholder back in losses a greater percentage of the premium dollar than any other auto insurance company in the country, while still providing a profit to the company. I always have been attracted to the low cost operator in any business and, when you can find a combination of (i) an extremely large business, (ii) a more or less homogenous product, and (iii) a very large gap in operating costs between the low cost operator and all of the other companies in the industry, you have a really attractive investment situation. That situation prevailed twenty-five years ago when I first became interested in the company, and it still prevails.

The company managed to nullify this advantage - and even more than nullify it - by inadequate recognition of loss costs through poor techniques of loss reserving. This led to improper pricing of product, with the result that a product which could have been sold at a profit was sold at a loss. But the important point to note is that the company had not lost its position as a low cost operator; they merely had

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mismanaged their loss information which caused the product to be priced inadequately. I believe the advantages of a 13% acquisition cost ratio are as important as ever. I also believe that practically no other companies are going to achieve costs near that figure in the future. Therefore, GEICO, properly managed, should prosper if they can pull themselves back from the financial precipice.

I like very much what Jack Byrne says about reducing policies in force. It seems to me that such an approach - rather than an obsession with growth - is very likely to reconstruct the situation whereby they can give the policyholder an unusually high percentage of the dollar back in losses and still make good profits for themselves

3. The crucial factor, then, becomes whether they can get past their present financial difficulties. Much of the press - witness Time last week - assumes that they can't. Until recently, I was unclear myself as to their possibilities in this regard. If they had been at all wishy-washy in obtaining rate increases or biting the bullet generally, I don't think they would have made it. However, the size of the rate increases they have instituted, along with the underwriting results they have published for April and May, have convinced me that their combined ratio will come down to tolerable limits within a fairly short time.

Even this would not have been enough if Mr. Wallach were inclined to put them into receivership because of the unwillingness of the industry to accept his 40% plan. When he did not move to do so after the June 23rd deadline, it convinced me that he was not going to act precipitously to terminate a business that fundamental economic logic still dictated had a bright future ahead of it. When he did not bow his back over the non-subscription to his 40% plan, I believe the company's future became assured. I decided then to buy stock, which is the most tangible evidence I can give you as to my assessment of the Company's chances for survival.

Therefore, George, I will take the responsibility for making the decision that GEICO survives as a business entity. You should make any underwriting judgments that you wish, with this as the premise - if I am wrong about their survival, it will be my fault and not yours. I do not want to go overboard because of sentiment,

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but I certainly want us to make every effort to come up with proposals that make business sense to us and are useful to them. I do not want more of the overall quota share because I consider the terms too disadvantageous to the reinsurer, all things considered. But, if a property treaty can be put together with a prospect of gain that more than balances the risk of loss, let's proceed.

Sincerely,

Warren E. Buffett

WEB/glk