The Financial Condition and Regulation of Insurance Companies: An Overview

*Richard E. Randall and Richard W. Kopcke**

Throughout much of the twentieth century, the large insurance companies have been popular symbols of unquestioned strength and stability. The image was not much different for professionals in the financial community: the risks were perceived to be modest in large, diversified insurance companies; managements were considered conservative; and ratings generally ranged from superior to excellent.

A crack appeared in the facade in 1988 when the fourth largest life insurance company sustained well-publicized losses that ate deeply into surplus, but this was considered to be an isolated situation. However, in October 1990 questions were raised about real estate problems in the life insurance industry after the ninth largest life company sustained a major loss as a consequence of a write-down of real-estate-related assets. The value of insurance company stocks declined in late 1990 as the financial community began to take a hard look at the recent changes that had taken place.

During the spring of 1991 the press increasingly focused on the industry, once it became evident that the life subsidiaries of First Executive and First Capital were impaired as a consequence of substantial investments in junk bonds. The seizure of these relatively large life companies by regulators brought to the fore the issues of guaranty fund protection and liquidity runs.

In the summer of 1991, the Federal Reserve Bank sponsored a conference to examine the dramatic changes in risk factors that have transformed the seemingly stable and dependable insurance industries

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into industries that could arouse widespread public anxieties. How pervasive are the weaknesses that have shown up in a few large insurers? Is there a danger that widespread liquidity pressures could develop? What changes should be made in regulation or in arrangements to protect customers of insurance companies? These are some of the primary questions addressed. Although the immediate concerns have been largely associated with life insurance companies, the conference also devoted considerable attention to property–liability insurance, which perhaps is inherently more risky.

Six papers were presented, each with two or three discussants. The first paper considers insurance companies as financial intermediaries, examining their role in credit markets and the risks inherent in the balance sheets of both life and property–liability companies. The next two papers analyze the structure, conduct, and regulation of domestic life and property–liability insurers. The fourth paper discusses the structure of insurance companies abroad. The final two papers evaluate public policy questions relating to domestic life and property–liability insurers.

A major issue is the quality of the assets currently held by life insurance companies. Some participants stress that the outlook for commercial real estate is negative in a number of regions and that several large companies are heavily exposed. The inadequacy of the capital cushion relative to potential losses is noted. Industry representatives argue, however, that the nature of their commercial real estate assets is distinguishable from that of assets held by commercial banks, and that problems are limited to a few institutions and not systemic to the industry, as was the case with the thrifts. It is generally agreed that no solvency threat is impending for the property–liability industry, although various areas of vulnerability are discussed, including potential exposure to environmental catastrophes. Much attention is focused on the ability of state guaranty funds to function effectively in large failures, and on the nature and degree of protection that should be provided to customers.

Industry representatives and some academics see little need for a federal role in supervision. Some participants argue for a limited federal role, with reinsurance and international activities examples of areas appropriate for federal regulation. Others argue for a more extensive federal role in solvency regulation, although no one advocates eliminating state regulation. With respect to property–liability insurers, however, some argue for phasing out state rate regulation and placing reliance on competitive forces to control prices.

A difference of opinion is apparent between those who would place more responsibility on regulators to prevent excessive risk concentrations from developing, and those who would limit guaranty fund protection in order to enhance market discipline as a constraint on industry risk-taking. Several participants note weaknesses in accounting and the difficulty outsiders have in trying to evaluate risk in insurance companies. Some also draw attention to the risk of liquidity runs on life insurance companies thought to be insolvent, illiquid, or weaker than their competitors.

The papers are rich in the variety of matters discussed beyond the major solvency issues mentioned here. Among these are the wisdom of removing rate regulation and/or antitrust immunity in property–liability insurance, federal tax policy with respect to the savings element in various life products, the shrinking presence of U.S. insurers in world markets, mark-to-market accounting, the appropriateness of retroactive loss loading in property–liability underwriting, and the prospects for industry consolidation.

Insurance Companies as Financial Intermediaries: Risk and Return

The paper by Richard Kopcke and Richard Randall was presented as a catalyst to discussion of the evolving risk profile of the industry and the supervisory challenges recent changes entail. It focuses on the implications for risk of the increasing role of life companies in offering investment products, and the vulnerability of both life and property–liability companies to rising interest rates, declining property values, and disappointing corporate profits. It stresses the need to deal promptly with dangerous risk concentrations and to support investment and other risk with adequate capital.

The authors begin by noting the importance of insurers as holders of corporate bonds and commercial mortgages. A number of life companies recently have been funding a significant portion of such assets with relatively short-term liabilities, mostly guaranteed investment contracts (GICs), thus raising both interest sensitivity and liquidity concerns. Property–liability companies are also vulnerable to increases in interest rates, since their claims are relatively short-term and irregular. Higher interest rates lower the value of their assets, which may have to be sold to meet claims.

The capitalization of property–liability companies has fallen significantly in the past 30 years, while their risks have not diminished. Capital ratios of life companies have remained essentially constant, but many life companies have undertaken investments that are riskier with respect to both possible default and vulnerability to interest rate increases. The paper documents the extent to which life companies with weak capital ratios hold particularly risky assets. The nature of some of the riskier investments of life companies, such as commercial real estate joint ventures, commercial mortgages, and leveraged buyouts, is such that outsiders have great difficulty in assessing the risk of individual companies.

The recent failures of a few relatively large life companies, and the widely reported vulnerability of additional companies to the depressed state of commercial real estate, warrant a review of how these dangers arose and how they could have been avoided. The authors present several case studies that show characteristics in common with the extraordinary asset quality problems experienced by large banks in recent years.

In general, risk concentrations developed over several years, during which time the institutions appeared to be in sound condition. A turning point occurred, adversely affecting the areas of risk concentration, and it soon became apparent that the institutions were severely, often fatally, damaged. With respect to both banks and insurance companies, supervisory action would have to have been directed at the risk concentration *before* the triggering economic event (disruption of the junk bond market, crash of real estate values, or the like). While the analysis by Kopcke and Randall does not equate the degree of the insurers' problems with those of banks, it does suggest that supervisory restraints on excessive risk-taking are equally appropriate in both industries.

Jeffrey Cohen sees a regulators' dilemma in the Kopcke/Randall proposal for early intervention to limit risk concentrations. He notes that the circumstances may not be clear when managements take actions that get them into trouble, and questions whether regulators should substitute their judgments for those of management or the markets. He also notes that regulators have a conflict between promoting solvency of the company and keeping insurance affordable to the consumer.

Cohen sees the fundamental industry problem as insufficient profitability, leading to greater risk-taking and weaker capital ratios. He attributes this in part to the presence of too many companies, and he would remove barriers to consolidation and not allow banks to enter the field. Cohen believes that life insurers are not profiting from the issuance of GICs because they write them at too narrow a spread between the yields they receive on their investments and the yields they pay on GICs, not allowing for an adequate risk premium.

He attributes the decline in property–liability insurers' capital ratios to a shift from property to liability lines, which permit a longer earning period before claims must be paid. He argues that the property–liability industry is not sufficiently profitable to support its present capitalization. Cohen calls for more mark-to-market disclosure and action to make the demutualization process easier.

In his comments, Thomas Maloney reviews the transformation of the larger life insurance companies over the past 20 years into multi-line financial companies. He finds that the majority of companies have adapted well to the more competitive environment. The larger companies are generally safer because of geographic and product diversification, and failures have generally involved small companies.

While a number of life companies underpriced products in recent years and overpaid to attract funds, most have rectified their mistakes. The few large life failures involved levels of risk-taking well above that of the rest of the industry, and the likelihood of widespread failures across the industry is low because of diversification and relatively high asset quality. Insurance companies perform better in a downturn than banks, a result of their greater geographic diversification and the character of their assets.

In reviewing current "reform" proposals, Maloney predicts that the outcome of the federal versus state regulation issue will depend on how quickly the states can strengthen supervision. He notes one fault of the current guaranty system: the prudent companies are burdened with the eventual losses incurred by their overly aggressive competitors. He also foresees industry consolidation in order to meet capital requirements.

Frederick Townsend's comments focus on the asset risks of life insurers, particularly the junk bonds that forced some rapidly growing companies into conservatorship and the real-estate-related assets that are creating capital losses in some of the large, established life companies. He emphasizes the poor credit quality of the junk bonds acquired, particularly by Executive Life, and he argues that the recent failures might not have occurred if regulations had limited junk bond concentrations.

Townsend points out that analysis of insurance companies must distinguish between the operating companies and the parent. He cites instances of damaged life companies with strong parents, and others where the problem was largely in the parent.

He notes the importance of product design and duration matching in avoiding runs by policyholders. Townsend also notes that while high capital ratios increase the odds of survival, they do not guarantee it. He concurs with Kopcke and Randall that capital ratios decline in the problem realization phase, not in the earlier, risk-taking phase.

The Structure, Conduct, and Regulation of the Life Insurance Industry

Kenneth Wright presents an account of financial conditions in the life insurance industry and the changed environment and competitive pressures that have so altered the industry in recent years. He reviews prior instances of liquidity pressures, the disintermediation periods of 1966, 1969, and 1979-81. He traces the development of new instruments, particularly universal life, variable life, flexible premium variable life, single-payment annuities, and GICs, and the corresponding shifts in investment strategies.

Wright finds the measurement of industry profitability difficult, but presents data suggesting a significant decrease in the 1979–87 period. He shows that capital ratios have declined in recent years, unless security valuation reserves are included in capital, in which case they have been virtually unchanged for the past decade.

Wright estimates that the life insurance industry holds $60 billion to $70 billion in junk bonds, but notes that the historical default record on corporate bonds has been favorable, and an important offset to the increased holding of riskier bonds has been greater holdings of Treasury and agency securities. With respect to commercial mortgages, Wright notes the rising delinquency numbers, but points out they have not yet reached the peak levels of 1976.

The industry is greatly concerned about the solvency issue even though it believes that serious problems are limited to relatively few companies. An insurance company failure exposes even healthy firms to the danger of runs, and the integrity of life insurance products may be called into question, deterring purchases.

Guaranty fund assessments are also an issue, although these payments can often be passed along to the states in the form of tax credits. The industry has supported efforts to modernize state solvency regulation and improve coordination between states through the work of the National Association of Insurance Commissioners (NAIC).

Wright concludes that the industry is not as financially sound as it was a dozen years ago, as a result of reduced profitability and greater financial risks. He sees the industry as having been forced by competitive pressures to accept higher risks, while the state regulators have had to struggle to stay abreast of marketplace developments. Wright sees the troubles of a few companies as presenting real problems for the industry and its regulators.

In his discussion of Wright's paper, Terence Lennon contrasts the environment for life insurers that existed in previous decades with the one that emerged in the late 1970s and early 1980s as a result of the destabilization of interest rates. Insurance customers were transformed from savers to investors, and life companies developed new products that met customer demands but increased interest rate risk and credit risk for the insurers.

A decline in margins—the difference between the yields earned on assets and those paid on liabilities—depressed capital ratios somewhat; more importantly, various accounting innovations such as securitization and financial reinsurance diminished the validity of book capital. The cushion that had long existed because of the industry's conservative accounting disappeared.

Lennon uses the Executive Life case to illustrate that aggregate limits can work for insurance companies, but do little good if imposed after companies have overinvested in risky assets. Lennon believes that conditions now are right for the adoption of a risk-based capital measure. He anticipates some federal regulatory role, and suggests greater conservatism could be induced in the industry through federal tax policy. Lennon foresees a 20 percent reduction in the number of life companies during the 1990s.

Kenneth Pinkes directs his comments to the fundamental forces he sees at work in the financial services industry. His message is that business risk will continue to rise as the successful innovators become more efficient and stronger and the weak become weaker. Financial institutions, including insurance companies, will become more susceptible to shocks.

Pinkes identifies two groups of fundamental forces, the effects of information technology and changes in the regulatory and public policy environment. The first set of forces will result in product unbundling, economies of scale in a broader range of products, and managerial complexity. Among the second group of forces will be greater tolerance for concentration, greater willingness to subordinate regulatory sovereignty for common global or regional standards, greater acceptance of the blurring of boundaries between regulated and nonregulated sectors, and greater insistence on market discipline. These forces will place increased demands on managements already under severe testing.

Robert Schneider challenges Wright's conclusion that the life industry is not as financially sound as it was a dozen years ago. He notes that the introduction of interest-sensitive products permits companies to compete on the basis of volatile interest rates without providing overly risky guarantees with respect to rates in the distant future.

For mutual companies, participating whole life policies are able to compete with newer products such as universal life because the dividend paid to policyholders has always included a significant contribution from interest earned in excess of the guaranteed rate. It was primarily the stock companies that had to redesign their products to compete in the environment of the 1980s. While annuity products, both single-premium deferred annuities and GICs, generate more investment risks, they have little or no mortality risk. The use of sophisticated investment management techniques can insulate an insurer fairly well from interest rate risk. The recent shift toward greater holdings of liquid assets has mitigated the increased liquidity risks of GICs.

The level of public concern over life insurance companies' holdings of junk bonds is misplaced except with respect to a very few companies, Schneider states. Most holdings are in the least risky category of junk bonds, and much of what is classified as junk is private placements with greater security than the stereotypical junk issue. Mortgages and real estate investments represent a more significant asset in most life companies, but even here concerns seem overstated. The character of insurance company real estate loans is quite different from the construction loans held by banks. Schneider considers the severity of the real estate problems of life companies to be comparable to those of the 1975–76 period, which did not threaten company solvency.

The Structure, Conduct, and Regulation of the Property–Liability Insurance Industry

J. David Cummins and Mary Weiss address a number of complaints, accusations, and expressions of concern with reference to property–liability insurers. For the most part they find little legitimate basis for these particular areas of dissatisfaction with the industry, but they do identify some serious problems that need to be examined.

The authors find the industry to be competitively structured in most business lines, with numerous firms, relatively easy entry, and satisfactory concentration levels. Much of the blame for premium inflation is put on factors beyond the control of the industry. They find the organizational structure of the industry, including its distribution systems, to be logical. They examine cash flow underwriting—that is, reducing prices during periods of high interest rates in order to increase cash flow and have more investable funds—and conclude that it is a natural practice in competitive markets.

The authors also discuss retroactive loss loading, where insurers price new policies to help absorb past losses. They present an argument that insurers can, and perhaps must, price in this way in situations where a number of insurers incur abnormal losses at about the same time.

Cummins and Weiss find internal rates of return and returns on equity to be reasonable, despite complaints by some that profits are excessive and protests by the industry that profits are insufficient to support an adequate surplus. However, they do see supply problems in the auto and workers' compensation lines if profitability is not improved, and they note the correlations between inadequate pricing of certain lines and intensive rate regulation.

The authors do not see any clear indication of an impending insolvency crisis among property–liability insurers. However, they express unease with the level of reinsurance receivables to surplus and with the fact that many reinsurers are virtually unregulated. They are also nervous about the quality of bond portfolios, fearing that some companies have invested a substantial portion of their assets in bonds of near-junk quality. In general, Cummins and Weiss consider solvency surveillance by regulators to be inadequate. They call for improved statutory statements both to facilitate improved surveillance and to permit more sophisticated research on the underwriting cycle and the causes of insurance crises.

Roger Joslin reinforces the Cummins and Weiss arguments that the property–liability insurance industry is intensely competitive, and that much of the rhetoric concerning affordability, availability, insurance cycles, and profitability is unjustified. Joslin emphasizes the political demagoguery associated with much rate regulation, and clearly sees little justification for such regulation or for barriers to firms exiting a state or line of business.

He does not see the industry facing a solvency crisis, and he argues that most failures of property–liability companies are preventable, or at least containable if laws are enforced and regulatory action is timely. Joslin sees a need to improve insurance accounting, to hold reinsurance to a high standard, to be skeptical of particularly rapid growth, and to defer the booking of underwriting profit until well after the close of the accident year. Joslin would also reduce the profit opportunities and increase the risk of loss to insider manipulators through a broader definition of voidable preferences and easier reversal of detrimental transactions with financially interested parties.

James Stone applauds the Cummins/Weiss paper for the issues it raises, but wishes the authors had gone further in developing answers to the difficult questions they raised. On the subject of competition, Stone notes that direct response insurance marketing can produce the lowest distribution costs, as a result of economies of scale. Under regulatory schemes that look only at cost and ignore the level of service provided, direct writing would be favored over independent agents. This could lead to a more highly concentrated industry, to the detriment of competition.

Since the authors do not identify the cause of commercial insurance cycles, Stone offers his own theory. He attributes such cycles to market signaling, or use of competitors' price movements as a basis for a firm's price changes. This phenomenon exists because of a dearth of hard evidence on which to base pricing decisions, and will continue as long as underwriters lack the necessary information.

With respect to solvency, Stone disagrees with the authors' suggestion that, without further research, the solvency threat to the property–liability insurance industry cannot be distinguished from the savings and loan disaster. Investment returns are a sufficiently small component of price, and market shares sufficiently price inelastic in the short run, to keep the industry's risk exposure within bounds. A number of firms in the industry are likely to fail in the coming years, however, and the authors' complaints about obsolete accounting and weak reinsurance are valid.

Stone notes the authors' statement that availability and affordability of auto insurance are beyond the control of the insurance industry. He believes that it is in the industry's self interest to serve as a catalyst for change, lessening dependence on the tort mechanism, tightening fraud control, and reexamining the notion of compulsory insurance. He favors a tempering of rate spreads between high-cost urban areas and low-cost suburban areas.

The Structure and Regulation of Insurance Markets Abroad

Sotirios Kollias describes the insurance industries and regulatory regimes of the major industrialized countries and discusses the dramatic changes taking place in conjunction with European integration. Most European insurance markets have historically been national markets separated by restrictive regulation and other obstacles to entry. An exception is reinsurance, for which an international market exists. Insurance markets have been most highly developed in the United Kingdom, the Netherlands, Japan, and the United States, somewhat less so in France and Germany, and much less developed in the southern European Community (EC) nations. Kollias estimates that rates of return on investments by insurance firms have been highest in the United Kingdom because of U.K. companies' relative freedom to invest in equities. Some measures indicate that companies in the United States and Japan are less efficient than companies in some of the EC countries.

Nonlife companies in most EC countries have been losing money on underwriting but have continued to show profits as a result of sharp increases in asset values. Life companies in Europe have generally been profitable, but Kollias did point out that the five big composite (multi-line) companies in the United Kingdom lost more than $1 billion in 1990. These companies have, nonetheless, been involved in less damaging competition than their counterparts in the United States.

The separation of European insurance markets began to erode in 1988, and since then a series of changes have been underway. Kollias discusses the principal EC agreements, the Single European Act of 1987 which included a program of financial integration, and proposals for harmonization of supervision of investment services. Integration of insurance activities has followed two separate paths, with nonlife large commercial risk and individual life policies being sold abroad under home country control, but "mass risk" life and nonlife insurance being sold under host country regulations. More recent proposals are expected to permit the free supply of insurance under home country rules.

The lowering of international barriers and deregulation are rapidly producing a much more competitive environment for insurance activities in Europe. Important structural changes are also taking place through mergers, joint ventures, cross-sector subsidiaries, bank/insurance conglomerates, and network distribution alliances.

In most European countries banks have not been able to underwrite insurance, and life and nonlife companies have been segregated. This separation is likely to be ended soon. Banks have been allowed to distribute insurance products, although insurance companies have generally not been allowed to distribute non-insurance products.

The European integration of banking and insurance in the form of mergers, establishment of subsidiaries, and cross-participation contrasts with the strict limitations on such operations in the United States and the prohibitions in Japan. EC draft directives call for the close cooperation of insurance and bank regulators if a bank or holding company controls an insurance company, however.

Henry Parker points out that the insurance market in the United States, while still the world's largest, is slipping rapidly in its share of world premium volume. He criticizes the domestic industry because so few companies participate aggressively in the expanding overseas markets. While substantial impediments to entry exist in some national markets, it can be done and it is getting easier as a result of federal efforts toward freer international trade.

Parker sees 1995 as the earliest date for real insurance market uniformity in the EC. He anticipates some very substantial reductions in insurance prices in several countries, citing Italy, France, and Luxembourg as examples of the wide variations in premiums for indentical exposures. He also sees advantages in terms of expense reduction, product innovation, and achievement of critical mass. Distribution systems will be altered, with more insurance sold through branches of affiliated banks and other financial service providers. An important stumbling block to rapid completion of the insurance directive is agreement on uniform accounting practices.

One concern for U.S. companies expanding into Europe is the possible reemergence of protectionism, particularly if transition problems severely damage long-protected European companies. There is some risk that a reciprocity standard might replace national treatment, to the detriment of U.S. companies.

Parker notes the importance and potential of the insurance market along the Pacific rim. He also calls attention to the acquisitions of U.S. insurance companies by foreign insurers.

Steven Skalicky reviews insurance market structure in Asia, Latin America, and Eastern Europe to complement Kollias's analysis, which focused primarily on the EC. He makes it clear that barriers that preserve fragmented national markets are under attack around the world.

Asia has the potential to be the fastest-growing market in the 1990s. Japan, the dominant market in Asia, is characterized by a relatively few large companies, including most of the top 10 insurance companies in the world. Japanese companies have been strictly supervised and limited as to their range of investments. Proposals would liberalize the asset restrictions, and greater flexibility in premium rates was permitted recently.

While the Japanese market is technically open to foreign competition, entry has been difficult. Japanese insurers have not been aggressive in overseas operations, but have the potential for being so. The attraction of Asian countries is not current premium volume, but the potential for growth as they become more industrialized.

In Latin America, Skalicky is most optimistic about Mexico, where the insurance industry is growing rapidly and restrictions on outside ownership have been liberalized. The transition from state control in Eastern Europe eventually will also provide opportunities, as reforms permit foreign participation and ownership and economic changes produce growth.

Skalicky sees unprecedented challenges to the insurance companies, consumers, and regulators. Large insurers that have the capital and resources to penetrate rapidly growing insurance markets may, if successful, survive the global consolidation of the industry. Consumers should benefit from less expensive insurance, but will face increasing risks of insurer insolvency. Insurers' reliance on growth in the value of real estate and securities to offset underwriting losses eventually leads to problems. The challenge to insurance regulators to anticipate and deal with problems in foreign markets is formidable.

Public Policy and Life Insurance

Gerard Brannon proposes a framework for evaluating regulatory and tax policies in the life insurance market. He begins by distinguishing between the risk coverage and the savings elements in the products of life companies, noting the significant tax benefits of the savings component. He presents historical data to show that since 1955, life company reserves have shifted from life insurance to pension and annuity products and life insurance reserves have declined as a percentage of household financial assets. Life insurance in force as a percentage of personal income has increased, however, as consumers shifted from whole life policies, which have a large savings element and require greater reserves, to term insurance. Despite this trend, evidence suggests that consumers still buy too little life insurance.

State regulation of life companies requires the maintenance of adequate reserves and limits the investment risk that can be assumed. In the late 1980s, the historic redundancy in reserves appears to have eroded and investment restrictions failed to protect policyholders from the risk of new financial innovations or the danger of disintermediation. The recent development of variable and universal life policies has been accompanied by higher-risk investments, but also the opportunity for the investors to make risk choices.

State regulators provide limited solvency guarantees for policyholders, funded by levies on competing companies. In some states insurance companies may apply such levies as credits against premium taxes, effectively transferring losses from the industry to the states. Brannon notes the relatively small volume of guaranty fund assessments in the period from 1975 to 1989 and expresses the view that solvency problems currently facing life insurers are clearly not in the same league as the solvency problems of banks and thrifts.

Brannon points out that the Pension Benefit Guaranty Corporation (PBGC) and state guaranty funds are competitors. When a company purchases an irrevocable contract for an annuity to cover pension liabilities, the guarantee shifts from the PBGC to a state fund. This may work to the benefit of the employer but to the detriment of workers, who have no say in the choice of an insurer. Nonetheless, Brannon argues against federal support of such annuity obligations, using the First Executive case to illustrate his point.

If it is in the public interest to encourage life insurance purchases for the protection of dependents of breadwinners, Brannon would support a guarantee of the ability of insurance companies to fulfill term life insurance contracts, and he would expect such a guaranty program to be successful. However, he would not support the protection of savers and he deplores the current tax advantages that encourage the intermingling of insurance and investment features, complicating the development of an appropriate guaranty scheme for insurance.

Joseph Belth confines his discussion to the issue of federal income taxation of the inside interest in cash-value life insurance and life annuities. Individuals tend to postpone the distressing subject of life insurance, and therefore a major expense for insurance companies is the commission paid to agents to perform the "anti-procrastination" function. Because natural premiums for life insurance are very low for young purchasers, companies do not receive sufficient revenue to compensate agents. Furthermore, the very high premiums in later years tend to produce adverse selection as healthier members drop insurance. Both of these problems can be mitigated by level-premium, cash-value insurance, which creates a savings component. The federal income tax on the inside interest is generally deferred. Life annuities, which provide regular payments over an individual's lifetime, make sense only in periods of low interest rates, because one can obtain almost as high a return investing principal directly during high-rate periods without destroying the principal, as happens with an annuity. A life annuity may have a lengthy accumulation period before the beginning of the liquidation period, and here again federal income taxation on inside interest is generally deferred.

A theoretical argument can be made that deferred tax treatment of inside interest in these two situations can no longer be justified. Cash-value life insurance is of increasing benefit to high-income individuals, and life annuities are increasingly used solely because of tax considerations. Nevertheless, Belth argues that current taxation of the inside interest would have a "devastating impact on the life insurance industry and would threaten its very survival." He also believes the industry has sufficient political clout to discourage any legislative attempt to impose current taxation.

Earl Pomeroy brings a regulator's perspective to the issues raised by Brannon. He contends that the sophistication of regulatory oversight has been improved in response to the lower capitalization levels, slimmer profit margins, and higher risks found in the life insurance industry today. Pomeroy cites the improved system for bond evaluation, a model law covering bond concentrations, limits on junk bonds, and progress toward reserve requirements and limitations on other higher-risk investments. While such regulatory activity has the necessary effect of lowering investment returns and restricting capital flows to particular activities, it is wholly appropriate because solvency protection is the regulator's first priority.

Pomeroy discusses such consumer protection regulations as required disclosures of product characteristics and minimum product quality standards. He chides Congress for attempting to achieve social goals through the imposition of costly market restrictions.

With respect to guaranty funds, Pomeroy agrees with Brannon that they can dull consumer sensitivity to insurer risk exposure, but finds that they serve a critical role. Despite assessment limitations, Pomeroy is reasonably hopeful that the guaranty fund mechanism has sufficient capacity, on a state-by-state basis, to handle a major life insurance failure.

After briefly reviewing the history of state insurance regulation, including recent activities of the National Association of Insurance Commissioners (NAIC), Pomeroy lists several concerns state regulators have with federal regulation of insurance. He maintains that federal officials tend to overstate the solvency problem, because of their sensitivity to the thrift failures and because they view the Executive Life case as a harbinger of trouble for the life industry generally. Newly implemented state reforms should be given time to work. Pomeroy argues that political pressures could lead to a situation where federal solvency regulation is imposed alongside state regulation of rates with the two sets of regulators pursuing conflicting objectives. Pomeroy does not expect a specific federal regulatory proposal to have much political appeal, even though the general concept might.

Warren Wise challenges Brannon's characterization of the cash value in permanent life insurance as being equivalent to a savings account. He argues that it arises from the leveling of premiums and is an integral part of providing lifetime protection at an acceptable price. The tax-free inside buildup is a subsidy to encourage life insurance protection, not savings.

Wise acknowledges that the industry is more vulnerable to failure than it once was, although his proposals for dealing with the problem are at odds with Brannon's. Rather than limit protection to death benefits, as Brannon would do, Wise would cover all policyholders. However, he would want all interested parties to share in losses when an insurer fails, including insurance sales representatives, policyholders, and state governments.

Guaranty fund assessments should be risk-based and collected on a regular basis so that the heaviest impact will fall on those insurers most likely to fail. Sales representatives should have an incentive to recommend safe companies, and states should have an incentive to devote adequate resources to solvency regulation. State contributions could be in the form of the tax offset for guaranty fund assessments that already exists in several states. Insurance consumers should share the burden by recovering less than the full amount due them.

Wise would improve regulation by linking capital requirements to risk, strengthening investment restrictions, improving accounting practices, and better controlling reinsurance transactions. Regulators must be provided sufficient resources to carry out their responsibilities.

The question remains of who should administer solvency regulation, and Wise would prefer that it be done without federal involvement if the states can adopt and enforce strong, uniform solvency standards. However, if a federal role proves to be necessary, he would prefer that federal involvement be limited to the setting of minimal standards, oversight, and the ensuring of compliance.

Public Policy and Property–Liability Insurance

Scott Harrington makes some very specific recommendations as to what changes should, and should not, be made to property–liability insurance regulation. He would like to reduce guaranty fund coverage in order to increase market discipline. He does not think a case has been made for a federal regulatory role, and believes that federal supervision could actually increase total insolvency costs. Harrington would like to see the abandonment of state rate-setting, but would not alter the industry's antitrust exemption.

With respect to guaranty funds, Harrington argues that guarantees result in policyholders having reduced incentives to buy coverage from safe insurers; the market collectively has more information and knowledge than the regulators, and the spreading of insolvency losses through guaranty funds can reduce pressure on government to commit adequate resources to solvency monitoring. It would be desirable to require a large co-payment from the policyholders, especially those who are best able to monitor insolvency. Harrington also makes a case for post-insolvency assessments being superior to an accumulated fund. The arguments presented against federal regulation of property–liability insurers draw heavily on the thrift experience, and particularly the role of Congress in condoning forbearance for insolvent institutions.

Harrington argues that rate regulation of property–liability insurance has little or no justification, and he would limit the regulatory role to requiring appropriate information disclosure. The industry is highly competitive, with ease of entry, and market forces can most efficiently determine rates. Harrington contrasts the industry to public utilities, where rate regulation is necessary. Rate regulation can result in insurers exiting certain lines or states, reducing net worth and thereby increasing insolvency risk; it can also result in insurers being less innovative. Regulation can directly increase expenses and distract management as a result of the rate hearing process.

Harrington sees the cooperative development of policy forms and sharing of loss data as entirely constructive, lowering costs, easing entry, and increasing forecast accuracy. He sees the forecasting of future losses by advisory organizations as serving a useful function to the extent that they improve individual insurer forecasts. He is concerned that a substantial change in the industry's antitrust exemption could lead to higher prices and less stability, and result in a surge of costly litigation.

J. Robert Hunter vigorously challenges Harrington's characterization of the property–liability insurance market as highly competitive, as well as his proposal to remove rate regulation while preserving the industry's exemption from antitrust laws. Hunter presents evidence that the public does not have sufficient information to select insurance companies on the basis of cost or service quality. He also cites findings that collusion on rates has been the norm, not the exception, in the industry. Hunter reviews the mechanism by which the Insurance Services Office, an industry service organization, provides insurers with advisory rates. He argues that, even with plans to exclude expense factors from the rate data, some critical components of the rate formula will still be provided that instead should be calculated independently by individual insurers, if collusion is to be prevented.

Hunter could agree to easing or even phasing out rate regulation, but only if all anticompetitive forces were eliminated. Specifically, he mentions the antitrust exemption, the anti-rebate laws, the anti-group laws, the barriers to entry by banks, the information gap, and the underwriting selection problem.

With respect to solvency, Hunter challenges Harrington's proposal to decrease guaranty fund coverage in order to improve market discipline. He would expand coverage for personal lines and small businesses. Even with respect to large commercial customers, he notes that loss of insurance protection could have secondary effects on the public when the business, as well as the insurance company, fails. Hunter calls for federal minimum standards for solvency regulation, and direct federal regulation of alien reinsurance and alien surplus lines markets.

Robert Litan agrees with most of Harrington's points, but he would not reject a federal solvency role and would draw different lessons from the thrift crisis. Litan faults the state regulators for their performance in connection with the larger failures of property–liability insurance companies in recent years. He attributes recent efforts by the NAIC to improve state regulation to the threat of federal regulation. Litan proposes creating a federal regulatory program and a national guaranty fund system as an alternative to state regulation and guaranty funds. Insurers that chose the federal system would no longer be subject to rate regulation. While Litan acknowledges some adverse selection problems with his proposal, he sees it as a way of forcing reform of the state systems, or having property–liability insurance regulation gravitate to the federal level.

Litan draws on his interpretation of the thrift crisis to support the idea that a pre-funded guaranty system would be superior to the usual post-insolvency assessment procedure. He points out that thrift regulators engaged in forbearance largely because of insufficient funds to resolve failed institutions.

Litan is concerned that major exogenous events pose a substantial threat to the industry, citing specifically a potential major earthquake and possible court rulings making insurance companies responsible for the cost of cleaning up hazardous waste sites. He suggests steps that could be taken in advance to protect the industry from being overwhelmed by such calamities.

Richard Stewart briefly outlines what he sees as the major issues in rate regulation and in dealing with the underwriting cycle. He then turns to the issue of solvency and argues that insolvency is a natural outcome for a property–liability insurer.

It is the liabilities of the insurer, not the assets, that are of most concern, and these liabilities extend far into the future. In Stewart's view, the future is not going to be like the past, and therefore it is nearly impossible to estimate the extent of these liabilities for pricing or reserving purposes. In the general liability line the threats are systemic, further adding to the industry's susceptibility to catastrophes on the liability side. Moreover, the industry is intensely competitive, and the incentives and rewards are concentrated on the front end of a transaction, with willingness and ability to pay claims coming much later.

If it is the duty of the regulator to prevent insolvencies, it is very hard to accomplish this by early detection and swift action because of the uncertainty about the extent of the liabilities. However, it is easy to forbear and avoid recognition of insolvency for several years, thereby escaping responsibility. In Stewart's view, this perverse incentive for the regulator increases the risk of even greater losses.

Our system of compensation for accidents functions through an insured civil liability procedure. In the event of insurance company insolvency, the victims include not only direct policyholders but large groups of individuals, whose only link may be the use of a common product or exposure to a form of pollution, and who are terribly hurt by the insurance company insolvency. We should not think only of corporate America in considering guaranty fund protection surrounding the property–liability insurance system.

Stewart believes that state regulation, with improvements such as those currently in process, can do a satisfactory job of detecting and acting against emerging insolvencies. However, liquidation and guarantees for large-scale general liability insolvencies should be managed at the national level.

Conclusions

The ability of domestic insurance companies to meet their obligations is vital not only to the welfare of their customers but also to the economy and social fabric of the country. In recent years the structure of the life insurance industry has changed in a way that has increased the risk of major insurers becoming insolvent or illiquid. Capital ratios have not increased in response. At the same time the property–liability insurance industry has become more leveraged and perhaps more vulnerable to large-scale losses.

Opinions differ widely as to the extent and duration of the current weaknesses in the asset quality of life insurers, but it is generally agreed that state regulation and the system of guaranty funds are being materially strengthened by various initiatives. Experts disagree, however, about the ability of even strengthened state systems to avert solvency problems or to safeguard policyholders and others in the event of failures of major insurers. Agreement on the desirability and extent of protection to be provided for policyholders, pensioners, and savers dependent on an insurance company's ability to pay, would facilitate determination of what, if any, federal role is desirable in regulation or in administering guaranty funds.

Congressional interest in examining the insurance industry, continuing downgrades in ratings of individual companies, and the prospects for a prolonged period of depressed commercial real estate values, all suggest that insurance industry solvency issues will be with us for some time.