Public Policy and Life Insurance

*Gerard M. Brannon**

Life insurance is one of the most heavily regulated businesses in the United States economy. Because of the industry's importance to American families, to our economy, and to our tax system, policy decisions that affect life insurance products receive a great deal of scrutiny. That scrutiny is likely to increase in the wake of recent insolvencies. The purpose of this paper is to provide a framework for evaluating tax and regulatory policies in the life insurance market.

Life Insurance Products

Life insurance companies are in the business of providing risk coverage and investing the customer's savings. Traditionally, they offer insurance against three kinds of risk:

(1) Insurance against early death, which by analogy to insurance against fire should have been called death insurance, but in a masterstroke of salesmanship was called life insurance;
(2) Insurance against living too long, provided by life annuities; and
(3) Insurance against accidents and sickness, through accident and health insurance or disability insurance.

---

*Consultant, American Council of Life Insurance. The author is grateful for the assistance of Kathleen Utgoff, economist at Groom and Nordberg, for her many helpful discussions and for her analysis of trends in the life insurance industry. The author would also like to acknowledge the advice of Kenneth M. Wright, Richard Minck, and Stephen Kraus.

The life insurance business also provides products that allow for significant savings on a tax-favored basis. Savings products and risk coverage are not necessarily joint products. Of the three types of risk coverage offered, only the annuity requires the accumulation of significant savings. An annuity is an arrangement by which a group of people pool their savings and the survivors draw on the pool.

A short-term insurance policy against death, called term life insurance, does not differ significantly from fire or casualty insurance and involves a very small amount of prepayment, or saving. To avoid excessive administrative expenses in these kinds of policies, it is efficient to sell a policy covering a period of a year or two.

By contrast, permanent or whole life insurance policies involve more prepayment of premiums than term insurance, so the policy has an identifiable cash value; it is a store of individual saving. Saving and insurance motives can also be distinguished in the annuity field. Annuities certain are pure savings products with a fixed payment period; life annuities paid until death are insurance; and life annuities with a minimum guaranteed payment period fall between pure savings and insurance. Accident and health insurance can be handled like any other line of casualty insurance, but a special noncancellable form involves a savings accumulation similar to the savings element in ordinary life.

Joint Savings and Life Insurance Policies

Rationalizations for combining life insurance and savings have always existed. For example, one says that permanent life insurance is necessary to protect the customer against becoming uninsurable. But term policies can be guaranteed renewable if the company adds enough to the premium to cover the risk. And permanent life insurance is not needed to protect the customer from the high cost of term insurance at older ages. The customer pays this cost under a permanent life policy as well, but in ways that are not so apparent.

Some other rationalizations are not so easily dismissed (Belth 1967b). The "Christmas Club" reason for combining a savings product with a life insurance product is the discipline of regular payment. The "retirement" rationale says that when the need for life insurance decreases after retirement, the cash value of the joint savings and life insurance product can be used to help finance retirement.

Probably the most important reason for combining savings and life insurance is that life insurance savings are taxed less heavily than many other kinds of savings. Life insurance savings receive the treatment that all savings would receive under a consumption tax. Two other forms of savings that receive favorable tax treatment are pension savings and the savings in the form of home ownership. Pension plans are slightly less

Table 1
Distribution of Life Insurance Company Reserves
Percent

	1955	1975	1989
Life Insurance	72.4	63.3	29.9
Health Insurance	.8	2.7	2.8
Pension and Annuity	26.8	34.1	67.3

Source: American Council of Life Insurance (1990).

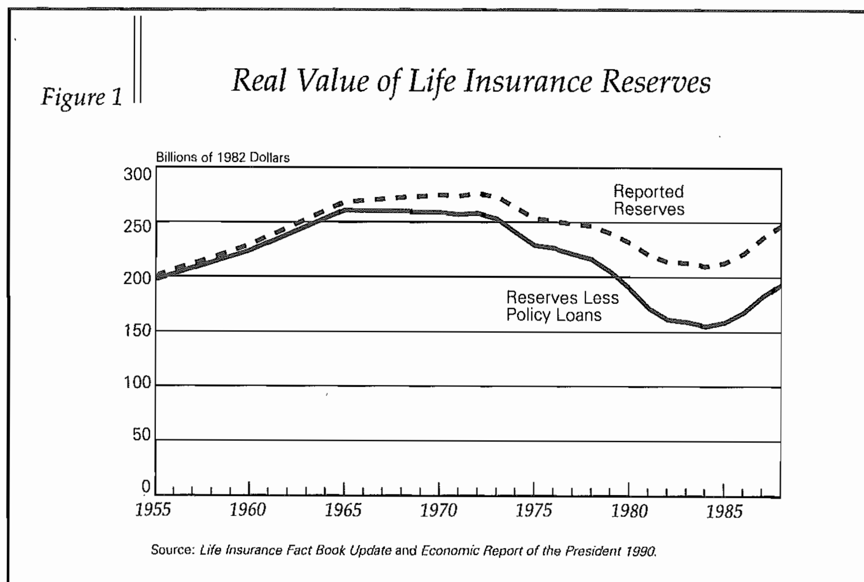
tax-favored than life insurance because pensions are taxed after a certain age whether or not the funds are saved. Home ownership is more favored than life insurance savings; no tax is paid on the income in kind produced by a home, and mortgage interest payments and real estate taxes are deductible. Most other forms of savings, including bank and thrift deposits, are taxed on an income basis; namely, interest earned is taxed annually.

But the income tax system does not provide the only, or even the most important, tax subsidy to financial institutions. Federal deposit insurance provides a substantial subsidy to banks and an even larger subsidy to thrifts. The Securities and Exchange Commission (1991) recently completed a study of FDIC insurance and concluded that the value of deposit insurance is three to five times greater than the premium collected. During the 1980s, the annual value of this subsidy was $20.3 billion. By comparison, the value of the tax subsidy to life insurance (which is called a tax expenditure) was measured at slightly less than $8 billion in the 1992 federal budget (OMB 1991, Part III, p. 17). Total bank deposits are far greater than the liabilities of insurance companies, however, and the relative subsidy is similar per dollar of liabilities. The SEC study concluded that the subsidy to banks amounts to about 100 basis points, a 16 percent subsidy when interest rates are at 6 percent. By comparison, since the average marginal tax rate of policyholders is in the neighborhood of 20 percent and some of the inside buildup in life insurance is taxed when policies are surrendered, the tax subsidy to life insurance is under 20 percent.

Historical Business Patterns

Table 1 shows how the life insurance company business has shifted over time, away from traditional life policies and into the annuity business, which is largely group annuities for pension plans. In 1955, nearly three-quarters of all the reserves held by life insurance companies were life insurance reserves, with slightly more than one-quarter in

Figure 1 *Real Value of Life Insurance Reserves*



Source: *Life Insurance Fact Book Update* and *Economic Report of the President 1990.*

pension and annuity reserves. By 1989, the proportions were nearly reversed. Much of this change is a result of the enormous growth in the pension business but a good deal of the change can be attributed to stagnation in the life business. Figure 1 shows the real value of life reserves since 1955. Adjusted for loans to policyholders, which do not decrease reported reserves, real (1982 dollars) life insurance reserves were lower in 1988 than in 1955. Even without adjustments for policy loans, real life reserves are lower now than they were throughout most of the 1960s and 1970s. Both measures of reserves have grown in real terms since the mid 1980s, however.

One reason for the anemic pattern in life reserves is that households have moved away from life insurance products with a savings component (a positive cash value). Term insurance, which requires fewer reserves than permanent life, has become more popular. Figure 2 shows the distribution of insurance in force between term insurance and permanent life insurance since 1954. While term insurance accounted for only 16 percent of all insurance in 1954, it represented almost one-half the amount of insurance in force by 1989. It appears that even though life insurance can contain both savings and insurance features, consumers are increasingly separating their purchases of these products. Demand for insurance is increasing. Life insurance in force as a percent of personal income has increased fairly steadily since World War II, from 102.7 percent of personal income in 1950 to 196.3 percent in 1989.

This pattern in life reserves is apparent in household balance sheets

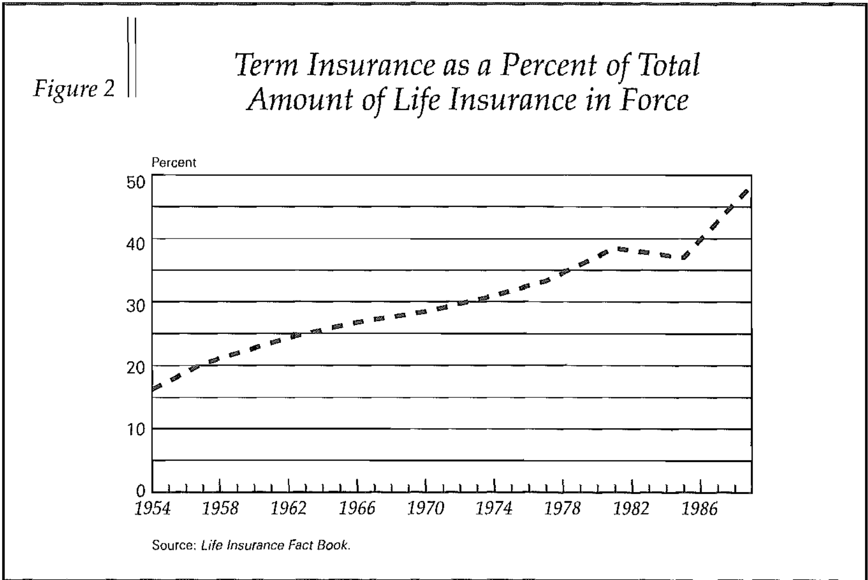


Figure 2 *Term Insurance as a Percent of Total Amount of Life Insurance in Force*

Source: *Life Insurance Fact Book.*

as well. Life insurance assets as a percent of household financial assets have declined from 7.3 percent of household assets in 1952 to 2.5 percent in 1989 (Figure 3). During that period households shifted their financial assets away from savings in life insurance products and direct owner-

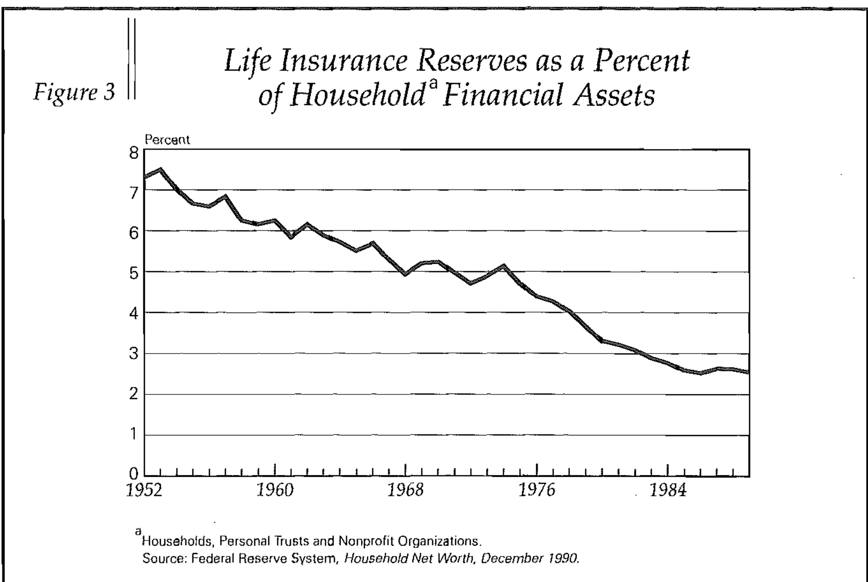


Figure 3 *Life Insurance Reserves as a Percent of Household[a] Financial Assets*

[a] Households, Personal Trusts and Nonprofit Organizations.
Source: Federal Reserve System, *Household Net Worth, December 1990.*

ship of corporate equities to two other tax-preferred savings vehicles—homes and pensions (Board of Governors of the Federal Reserve System 1990). The share of household assets in mutual funds also increased beginning in the late 1970s with the rise in money market mutual funds. The growth of mutual fund savings is particularly noteworthy because this product offers neither the guarantees nor the tax advantages (for non-pension funds) that are available to other forms of savings. In 1989, total assets of mutual funds ($1 trillion) rivaled the assets of life insurance companies ($1.3 trillion); and they amounted to one-half the assets of commercial banks ($2.1 trillion) (Investment Company Institute 1990).

Life Insurance Regulation

From an early period in the United States, the sale of life insurance has been regarded as a matter of unique governmental concern. In order to make certain that funds are available to cover claims, insurance companies are required to set aside reserves. Both the calculation and the investment of these reserves are regulated by state law. The regulation of actuarial reserve methods goes back to the work of Elizur Wright in Massachusetts in the 1860s and the general pattern of the other state regulations goes back to the findings of the Armstrong Commission in New York in 1906.

The topic, public policy and life insurance, raises questions about whether and how government should intervene in the life insurance market. This discussion will begin by examining some of the arguments used to justify government intervention. It will also refer to the politics of regulation, recognizing the considerable literature that emphasizes the "capture" of regulating institutions by those regulated.[1]

Special Problems in Life Insurance Markets

Adverse selection. Even though the private insurance market is a market for dealing with risk, insurance companies profit by avoiding risks. Successful insurance is based on the correct pricing and pooling of risk. To the extent that companies can estimate different probabilities for different classes of customers, it is profitable to introduce premium differentials. Where they are prohibited, companies with more high-risk customers will be less solvent, creating strong pressures to avoid high-risk customers. Despite these economic forces, premium differentials are sometimes viewed as unacceptable discrimination.

[1] For a survey and some testing of alternative theories, see Peltzman (1989). And Meier (1988) uses this approach to analyze life insurance regulation.

Moral hazard. Many forms of insurance tend to inflate the cost of the insured event because they weaken the incentive to avoid these events. Moral hazard is a more serious problem in the health insurance market than in life insurance. Widespread misuse of health insurance increases the use of medical services, drives up prices, and aggravates the problems of the uninsured. Standard contract features such as co-payments and deductibles are used to reduce moral hazard. In addition, services most susceptible to moral hazard, such as cosmetic surgery and psychiatry, are sometimes excluded from coverage. Providers of these excluded services have successfully lobbied against coverage restrictions in some states. The end result has been an increase in the price of health insurance that has reduced coverage. The percentage of all workers covered by a group health plan declined from 62 percent in 1980 to 57 percent in 1987.

Consumer information. Still another feature of the life insurance market often used to justify regulation has to do with the complexity of many life insurance products, which makes it difficult for consumers to evaluate products rationally. Insurance pricing is so complex that it gave birth to a new branch of mathematics. Some aids are available to consumers, such as the work of Belth, the Nader organization, and Consumer Union.[2] Some evidence shows that consumers do evaluate policies rationally and that poorly priced policies do not survive in the marketplace. Winter (1981) found very little variation in the prices of insurance policies when all aspects of the policy are taken into account.

The Armstrong Commission (1906) made some early efforts to standardize contract forms but substantial variety still remains. A long-standing regulatory effort has been to simplify contract language. The growing field of private insurance for nursing home costs is particularly beset with the problems of defining the insurable event and dealing with customer misperceptions about coverage under the policies.

Rationality of provision for death. Life insurance companies commonly allege that consumers have an irrational reluctance to think about death. The high selling expenses associated with life insurance policies are often justified on the grounds that individual agents are needed to assist customers in overcoming irrational avoidance behavior. The fact that life insurance salespeople rate fairly high in occupational ranking suggests customers think they get a valuable educational service from life insurance agents.

The contention that consumers buy too little life insurance is supported by economic analyses. Auerbach and Kotlikoff (1989) exam-

---

[2] Interestingly, Belth, a pioneer in the field of educating consumers about life insurance, felt impelled to resign from a Consumer Union panel on life insurance and publish a technical journal article explaining his differences (Belth 1967a).

ined life insurance purchases using three Surveys of Consumer Finances. The data provided information on some 1,200 families with both spouses present and one or two spouses working. The data included information on earnings, wealth, and pension plan entitlement, including Social Security and life insurance coverage. Assuming that actuarially fair annuities were available, the authors calculated for each family the lifetime consumption that could be afforded while both earners were alive and the lifetime consumption that could be afforded if one earner died.

The authors made a conservative assumption that a surviving spouse would need 50 percent of the previous affordable consumption to maintain the accustomed living scale if one spouse died; if a family had made provisions for less than 70 percent of this, the family was defined to be underinsured. Auerbach and Kotlikoff conclude that just over 30 percent of families are inadequately insured; for lower-income households the underinsured fraction is almost one-half. From this they conclude that the high incidence of poverty among widows is not merely an extension of lifetime poverty but a matter of insufficient insurance. A similar conclusion was reached by Myers, Burkhauser and Holden (1986).

Government Policies toward Life Insurance Companies

In the light of these special market features, this paper addresses four broad types of government policy toward life insurance companies: reserve regulation, investment restrictions, solvency guarantees and other consumer protections, and purchase inducements. To a large extent, the policies are interrelated; the implications of these interrelationships are discussed in the final section.

Reserve regulation. State insurance regulation requires that life companies be solvent after deliberate overstatement of liabilities. It is fairly obvious that, looking backward, a state of insolvency could be attributed to having charged too little for the service provided and/or having dissipated the receipts before rendering the service. Reserve regulation addresses both problems by requiring that life companies have at all times enough book assets to cover future death benefits on all policies, assuming that mortality is less favorable than the most likely level and that interest earnings on assets are lower than the most likely level. In addition, expenses of acquiring the business (commissions) must be deducted immediately rather than amortized over the life of the policy.

Because of the conservative position that states have taken with respect to acquisition costs, a new company that rapidly expands its life insurance business will have a poor balance sheet. It is standard practice within the industry for a growing company with a critically poor balance sheet situation to seek "surplus relief" through reinsurance. Such a

company has a group of assets—life insurance policies that it has issued—worth more than a state insurance commission will recognize. The issuing company can circumvent conservative accounting rules by selling policies to a reinsurer.

In the 1960s and 1970s, reserves for life insurance companies as a whole were conservative and capital was underestimated. One clear indication of this was an excess of market value over book value during this period (Belth 1967b). Those were decades of steadily increasing interest rates, resulting in reserve interest rates chronically below market rates. However, it appears that book and market rates in the late 1980s were much closer for life insurance companies (Kramer 1990, p. 27). Required reserves appear to be more realistic as well.

What about the quantitative aspect of reserve regulation? Do reserves need to be so large? Do the underlying assumptions have to be conservative? Most countries have such rules but they vary in specificity from the mere requirement of actuarial certification in the United Kingdom to the highly specific rules in Germany.[3] Despite the variation in reserve regulation, little difference has been found in the experience of insolvencies (Finsinger and Pauly 1986).

In 1977, Canada terminated its previous strict reserve requirements in favor of the British system of allowing companies some flexibility, subject to approval by an independent actuarial audit. Mathewson and Winter (1986) have studied the movement of life insurance prices in Canada in relation to interest rates both before and after reserve requirements were deregulated. Although it is not clear just how much conservative reserve requirements protected consumers, the authors concluded that the rigid reserve rules did tend to result in higher prices for life insurance. The results, however, were barely significant.

Investment restrictions. These restrictions limit life insurance companies to relatively risk-free investments and presumably make it unnecessary for the consumer to evaluate the riskiness of the company's investment portfolio. Sometimes they also preclude financial innovations such as junk bonds. Even before the advent of junk bonds, however, investment restrictions created problems because a "conservative" investment policy does not protect policyholders against inflation risk or the solvency problems that can arise when interest rates increase with inflation and policyholders withdraw funds.

In recent years developments toward incorporating more risky investments into the insurance framework have emerged. One technique is the variable policy, in which the savings element is invested in a segregated set of equities with the value of the savings element

[3] For more information on the British and Canadian systems, see Sondergeld (1989) and Kimball (1969).

indexed to the value of the equities. This form has been very popular in the annuity field, especially for pension plans, but in the life field, separate account policies remain experimental. Another variant is the universal life form, where the savings element is clearly demarcated and the yield on savings can be linked to a specific market indicator, such as the T-bill rate. It seems eminently sensible that life insurance savings should have a range of possible investments, relying on financial markets to adjust the return to the risk. Returns and associated risks should be clearly demarcated so that the investors making the risk choice participate in resulting gains and losses.

The experience with sharply fluctuating interest rates in the past 30 years has led to the virtual disappearance of the old, nonparticipating policy under which the insurance carrier was insuring a minimum rate of return as well as against mortality. The two major interest-sensitive products are the participating policy—the typical mutual policy—and variants of the universal life policy sold by stock companies. The two reflect interest rate changes differently. The participating policy is compelled by regulation to spread interest earnings evenly over all policyholders, old and new. Under the universal life form, which clearly delineates the insurance and savings components of a policy, a cohort of new policyholders can be assured a current earning rate on the savings component; old policyholders experience current rates only as their old investments mature. In a period of rising interest rates the universal life form offers obvious advantages in attracting new policyholders, and many mutuals have formed stock subsidiaries to sell universal life in recent years.

Solvency guarantees. State regulators can intervene in the affairs of a nearly insolvent company and, if necessary, can impose levies on other life companies to cover the deficiencies of the insolvent company. These levies are sometimes credited against premium taxes so that, effectively, state funds are used for guarantees. From 1975 through 1989, the state guaranty fund system has resulted in assessments of $315 million for health insurance, $125 million for life insurance, and $124 millon for annuity contracts (ACLI Task Force 1990). Only $62 million of the Baldwin United losses were covered by state guaranty funds. The remaining losses were covered by advances of about $150 million from brokers (under threat of litigation) and $50 million from life insurance companies (in addition to guaranty fund assessments).

Some observers predict growing insolvencies in the future (Leary 1991), and the collapse of First Executive has caused some alarm. But solvency problems in the life business are clearly not in the same league as the solvency problems of banks and thrifts. Some insurers have a high percentage of junk bond holdings, but overall, bond default rates have remained low (Sutton 1991). Total life insurance insolvencies, including Baldwin, over the previous 15 years equaled only 1 percent of

company capital and surplus in 1989. On the basis of a detailed review of financial indicators, a study commissioned by the Insurance Information Institute (Kramer 1990) concludes that in the life insurance industry, "trends that raised risk levels earlier in the 1980s have reversed themselves by the end of the decade." Kramer also concludes that the capital position of the weakest life insurance companies is far stronger than the capital position of the weakest banks and that it is "analytically bankrupt" to compare thrifts and insurers.

Other consumer protections. A traditional area of consumer protection has been the standardizing of policy forms and language. This is a long-standing issue in life insurance but it is an emerging problem for long-term care insurance. Given the growing cost of Medicaid, which now pays for one-half of nursing home costs in the United States, the regulation of long-term care policies is an important public policy issue.

A well-designed long-term care policy appears economically feasible (Friedland 1990). The major problem is that the insurable event is not well defined because the medical indications for nursing home care are not clearly established. A number of insurance policies are available but much unhappiness exists with both the exact coverage and the level of consumer understanding. The lack of definition in long-term care insurance can work both ways, to harm particular customers or to endanger the solvency of the insurance company. Earl Pomeroy, past president of the National Association of Insurance Commissioners, claims that "some consumer abuses are so severe as to raise questions about the very viability of the product." (Consumer Union 1991.) Some insolvencies have even occurred because of long-term care liabilities. No real alternative to welfare will be available for most nursing home care until a fairly clear insurable event with a calculable probability has been defined for long-term care insurance.

Although premium rates are regulated in the health insurance business, most states do not regulate life insurance premiums, relying on reserve requirements to ensure adequate rates and competition to prevent excessive rates. In addition, states routinely regulate policy forms to ensure full disclosure.

Some regulations seem to be more in the interests of agents than policyholders. All states forbid "twisting," where, allegedly, the policyholder is encouraged through misleading information to switch policies. Price competition through rebates of commissions is also outlawed in most states.

A few states have passed laws prohibiting certain rate differentials such as those based on sex. These laws are unlikely to survive because of the distortions that they create, not the least of which is above-market rates for some groups. After Montana passed the first unisex insurance law in 1983, lawmakers were inundated with complaints from parents of daughters whose car insurance rates soared.

The Employer Retirement Income Security Act of 1974 (ERISA) is the major form of consumer protection in the pension business. The impact of ERISA falls mostly on employers rather than on financial intermediaries because the most restrictive pension regulations are those designed to make sure that pension tax benefits are distributed equally among workers in a firm. Employers have been forced to redesign their pension plans several times in the last decade because of these regulations (Utgoff 1990).

Pensions are also subject to minimum vesting, funding, and diversification rules under ERISA. In addition, ERISA established an insurance program for defined benefit pensions. The Pension Benefit Guaranty Corporation (PBGC), the federal agency that runs this guarantee program, has experienced claims far in excess of original projections and the agency has had solvency problems virtually since inception (Ippolito 1989).

As guarantors of pension annuities, the PBGC and state solvency funds are competitors. When a company purchases an irrevocable contract for an annuity to cover pension liabilities, those liabilities shift from PBGC coverage to coverage under a state guaranty fund.

This situation has raised a number of concerns, particularly in light of the pension annuities sold by First Executive. The workers covered by these annuities had no say in the selection of the insurer, while the companies that sponsored the pension plan gained because of the high interest rates that attracted customers to First Executive. The federal government is considering a standard that would prohibit the purchase of annuities from unacceptable insurers. The design of such a standard has proved difficult, however, given that First Executive subsidiaries were highly rated until recently. The insurance commission in California wants the PBGC to make up for any shortfall in First Executive pension annuities. It is clear, however, that such an action would be the equivalent of a federal guarantee of life insurance companies, a highly questionable move in light of the record of other federal guarantee programs.

Unisex pensions are required by law. After the 1983 Supreme Court decision in *Norris v. Arizona Commissioner*, monthly pension annuities could not reflect longevity differences between men and women. Sex-based actuarial tables for pensions are an illegal form of sex discrimination. Carlson and Lord (1986) describe the predictable problems that this ruling has created.

Purchase inducements. The assertion that life insurance is underpurchased can be used to justify purchase inducements, which can range from the social provision of life insurance to a subsidy for private purchases. Federal law contains several provisions that are designed to increase insurance coverage. The survivor benefit structure of Social Security is compulsory life insurance. In addition, pension plans are

required to provide survivor benefits for spouses of vested participants. The federal tax code is used to provide significant purchase subsidies as well. A subsidy that is restricted to employed individuals provides for an exclusion from income of employer-paid group term insurance up to $50,000 of coverage. All policyholders are entitled to the tax-free inside buildup that is provided for cash value insurance.

The life insurance industry uses the argument that consumers under-purchase life insurance in order to justify retaining the tax advantage for life insurance contained in the tax-free inside buildup, the interest on the reserve accumulation. But this tax advantage subsidizes savings, not insurance against the death of a breadwinner. If an individual buys term insurance and separately accumulates savings in a bank account or a mutual fund, the interest on the savings is taxed annually as income of the saver, and no deduction is allowed for the term insurance premiums. If the savings are used instead to purchase permanent insurance, the interest is not subject to income tax if it becomes part of the death distribution or if it is used to pay for the insurance premium. The interest beyond that used to pay for term insurance may be taxed if the policy is surrendered, but only after considerable delay. The Treasury Tax Reform Plans I and II in 1984–85 recommended repeal of the inside buildup advantages, as well as repeal of the deferral possibilities in deferred annuities (U.S. Treasury 1984). These were largely rejected by the Congress.

The effort to subsidize life insurance purchases through the encouragement of savings-type life insurance makes it more difficult to guarantee the solvency of life companies. If we are highly concerned that dependents of breadwinners not be left without resources, the approach should be to encourage the purchase of term life insurance and to guarantee the ability of insurance companies to fulfill term life insurance contracts.

When the insurer is simultaneously a savings institution subject to investment risks, it becomes difficult to separate a guarantee of the insurance function from a guarantee of the investment function, although the case for protecting widows and orphans is clearly different from that for protecting savers in general.

The tax law also complicates solvency problems by offering the tax advantage of postponed income recognition for annuities, even for annuities certain. The postponement of income recognition until receipt appears reasonable in the case of life annuities that are in the payment stage. The taxpayer has accepted income postponement as a way of leveling receipts over the remaining lifetime and government should do likewise. Before the payment stage, however, the current taxation of investment income would be more consistent with the taxation of other types of savings that are not tax-preferred, namely savings in depository institutions and mutual funds.

The tax law subsidizes not only the purchase of insurance but also the purchase of insurance from small companies. It is clear from the simple statistics of large numbers that small life insurance companies are inherently more prone to solvency problems, and consequently less efficient (Geehan 1977). In the regular corporate income tax, a small company is given a rate reduction that reaches a top value of $11,750 at incomes between $75,000 and $100,000 and is then phased out up to an income of $335,000. For a small life insurance company additional relief peaks at $612,000 (at an income of $3 million) and does not phase out entirely until income is $5 million. The small life insurance company has 50 times as much relief as any other small company.

Tax scholars are unanimous that no basis exists for progressivity in the general corporate tax and even less of a case exists for small insurance companies because of their inherent inefficiencies in providing risk coverage. The small business provision in insurance tax law can only be described as misguided.

Overview and Conclusions

Government intervention in the life insurance industry is found in four major areas: reserve regulation, consumer protection, solvency guarantees, and purchase inducements in the form of tax benefits. Any evaluation of these policies must recognize that life insurance companies offer some products, such as pensions and health insurance, that are also sold by other financial intermediaries, and that the unique product of the industry—term life insurance—is often combined in a single product with tax-favored savings.

The most long-standing government policy toward life insurance is reserve regulation, including the control of investment quality. This policy appears to have been reasonably successful in achieving its announced purpose, consumer protection. Until recently, the solvency record of the industry has been remarkably good. This has not been achieved without cost, however. The investment restrictions have reduced the yield on savings and the price of life insurance has probably been kept a bit higher.

Other consumer protection efforts beyond reserve regulation are more difficult to evaluate. While some observers have complained that state governments have moved too slowly to make consumers aware of interest and time value in life insurance, the increased popularity of term life and universal life policies indicates that awareness has blossomed. The current battlefront over disclosure is long-term care. In this new and changing market it is not surprising to find efforts to provide insurance or to find that the existence of insurance changes behavior.

Nor is it surprising that companies will try to limit their exposure in ways that are not always transparent to consumers.

State solvency guarantees can be characterized as evolutionary products of healthy experimentation, with much input from the life companies concerned about the product image. Until recently, solvency problems have been minor. Some of these insolvencies can be blamed on the federal tax subsidy that results in increased numbers of small life insurance companies, because small companies inherently are more susceptible to failure.

We should expect a solvency guarantee program to be successful so long as it is limited to insurance contracts as opposed to investment vehicles. Term insurance alone requires limited reserves. Unanticipated changes in mortality do not appear to be a big financial threat for life insurance companies.

The state solvency guarantee policy may well be at a crossroad. As interest rates rose in the 1970s, the conservative orientation of insurance regulation began to chafe. One effect of increased interest rates was disintermediation, a familiar term to banking experts. The industry survived this fairly well, in part by offering new interest-sensitive products. The obvious dangers, however, appear when firms compete for investors based on returns. Many of the financial problems in the life insurance industry seem to be related to risky investments undertaken because of the pressure to guarantee high returns.

The state solvency guarantee programs should move in the direction of guaranteeing plain vanilla life insurance, which includes minimum guaranteed returns; speculative investment products should not be guaranteed. If a willing borrower and a willing lender agree to a product with an 8 percent yield guarantee, they should be free to do so, but no good reason exists to provide a solvency guarantee for this feature, even if the product is called life insurance. Similarly, a financial intermediary should be able to offer an investment with the return based on the yields of rates of junk bonds, even if this investment is in the form of an annuity or a life insurance policy. Since the extra return is based on extra risk, a guarantee is difficult to justify. No guarantee should be given on a pure savings contract.[4]

While a guarantee feature does attract investors, the life insurance industry probably could also attract funds to a non-guaranteed vehicle that would not be hobbled by the investment restrictions that a guarantee requires. Non-guaranteed mutual funds have prospered, while banks and thrifts that enjoy almost unlimited coverage have struggled.

The conclusions regarding the tax treatment of insurance are mixed.

---

[4] I am indebted to Warren Wise for clarifying my thinking on this point. He may not agree with the conclusion, however.

It appears that underinvestment in life insurance is a problem, particularly in low-income families. But the employer-paid group insurance subsidy is unlikely to get to the lowest-income workers, who are even less likely to receive any fringe benefits. The inside buildup tax exemption for policies that contain investments is also of little use to low-income workers.

What makes a judgment on inside buildup difficult is the erratic structure of the present U.S. income tax. Before 1986 much academic literature was written about our hybrid tax system—half an income tax and half a consumption tax. The Reagan tax reform effort in 1985–86 was a conscious movement toward a purer income tax. Since that time, the Congress has shown only a limited interest in a purer income tax and currently both the Administration and important segments of the Congress are vying to move back toward a consumption tax, with proposed capital gains relief, expanded IRAs, and Family Savings Plans.

Some very large segments of the savings flow in the United States are subjected to consumption tax treatment: pension savings, home equity, and savings invested in municipal bonds. One big savings flow that is denied consumption tax treatment is bank deposits. But bank deposits get an alternative subsidy in the form of a guarantee that is comparable to the tax exemption for the inside buildup.

Direct investment in a business through stocks, bonds, and most mutual funds does not get consumption tax treatment or a subsidized guarantee. Although much of the concern from the early 1980s about a hybrid tax system is still well taken, it is not clear whether we should resume the aborted march to a pure income tax or move to a consumption tax. Reasonable people disagree on this.

A great deal of effort has been devoted, over the past decade, to defining components of life insurance contracts that are ineligible for favorable tax treatment because they are deemed to be investment products rather than insurance. It is not clear how necessary this exercise has been to the achievement of a desirable tax system. Many other forms of savings that could be classified as investments are tax favored. Moreover, life insurance companies do not appear to be cornering the savings market through savings disguised as life insurance products; life insurance reserves are stagnant; the share of household savings accounted for by life insurance has declined; and consumers are increasingly purchasing term insurance which benefits little, or not at all, from the inside buildup. It is also not clear that a tax on the inside buildup would have resulted in a lower deficit, even in the near term. It could easily be argued that a tax incentive that kept funds out of banks and thrifts was a net benefit to taxpayers.

While it is not clear that the IRS should be working diligently to distinguish between investment products and insurance products, this distinction should be a major area of concern to officials at state guaranty

funds. As long as investment (savings) products are guaranteed, insolvencies will continue to occur because reserve regulations and investment decisions cannot anticipate every financial innovation. Moreover, entrepreneurs who see these innovations as opportunities rather than abuses of the guarantee system will always be present.

The conventional wisdom in the insurance industry and in Washington appears to be that a satisfactory resolution of the First Executive failure depends on full restoration of contractually promised benefits to all policyholders. Full restoration is believed to be necessary in order to head off intrusive and damaging federal regulation of the industry. But this line of reasoning is flawed. A policy of full protection of all contractual obligations will result in the same dynamics that have plagued banks and thrifts—mounting insolvencies, high premiums, and increased capital requirements.

The mutual fund industry is a better model for financial regulators than either the banking or the thrift industry.

References

American Council of Life Insurance. 1990 and updates. *Life Insurance Fact Book*. Washington, D.C.

———. 1990. *Report of the ACLI Task Force on Solvency Concerns*. Washington, D.C., September.

Armstrong Commission. 1906. Report of the Joint Committee to Investigate Life Insurance Companies. Albany, NY: Brandon Printing Co.

Auerbach, Alan and Laurence Kotlikoff. 1989. "How Rational is the Purchase of Life Insurance?" National Bureau of Economic Research Working Paper No. 3063, Cambridge, MA, August.

BarNir, Ron and Robert Hershbarger. 1990. "Classifying Financial Distress in the Life Insurance Industry." *Journal of Risk and Insurance*, vol. 57, March, pp. 110–136.

Belth, Joseph M. 1967a. "A Note on the Consumer's Union Life Insurance Series." *Journal of Risk and Insurance*, vol. 34, September, pp. 485–90.

———. 1967b. "Observations on Solvency in the Context of Life Insurance Regulation." *Journal of Risk and Insurance*, vol. 34, December, pp. 539–60.

Board of Governors of the Federal Reserve System. 1990. *Flow of Funds Accounts. Financial Assets and Liabilities, Year-End 1966–1989*. December.

Carlson, Severin and Blair Lord. 1986. "Unisex Retirement Benefits and the Market for Lemons." *Journal of Risk and Insurance*, vol. 53, September, pp. 409–18.

Cho, Dongsae. 1986. "Cost, Output and Scale Economies in the Life and Health Insurance Industry." *Journal of Insurance Issues and Practices*, vol. 9, January, pp. 12–26.

Consumer Union. 1991. "The Traps in Long-Term Care Insurance." *Consumer Reports*, vol. 56, June, pp. 425.

Derrig, Joanne. 1985. "Regulating Transactions Between Affiliates: A Comparison of the NAIC Model Insurance Holding Company Law with Its Federal Banking Law Counterparts." *Journal of Insurance Regulation*, vol. 3, June, pp. 444.

Finsinger, Jorg and Mark V. Pauly, eds. 1986. *The Economics of Insurance Regulation: A Cross-National Study*. New York, NY: St. Martins Press, Inc.

Fitzgerald, John. 1988. "Regulatory Lessons from Baldwin United." *Journal of Insurance Regulation*, vol. 6, March, pp. 285.

Friedland, Robert B. 1990. *Facing the Costs of Long-Term Care*. Employee Benefit Research Institute.

Geehan, Randall. 1977. "Returns to Scale in the Life Insurance Industry." *Bell Journal of Economics*, Autumn, pp. 497.

Huebner, S.S. 1959. *Economics of Life Insurance*. 3rd ed. New York, NY: Appleton-Century Crofts, Inc.

Investment Company Institute. 1990. *Mutual Fund Fact Book*. Washington, D.C.: The Institute.

Ippolito, Richard A. 1989. *The Economics of Pension Insurance*. Homewood, IL: Irwin.

Kimball, Spencer. 1969. "The Regulation of Insurance." In Kimball and Denenberg, eds., *Insurance Government and Social Policy*. Homewood, IL: Irwin.

Kramer, Orin. 1990. *Rating the Risks: Assessing the Solvency Risk in the Financial Services Industry*. December 31. New York, NY: Insurance Information Institute.

Launie, J.J. 1968. "Price Differentials in Life Insurance." *Journal of Risk and Insurance*, vol. 35, June, p. 283.

Mathewson, G.F. and R.A. Winter. 1986. "The Economics of Life Insurance Regulation: Valuation Constraints." In Finsinger, Jorg and Mark V. Pauly, eds., 1986 (see above).

Meier, Kenneth. 1988. *The Political Economy of Regulation: the Case of Life Insurance*. Albany, NY: State University of New York Press.

Myers, Daniel A., Richard V. Burkhauser, and Karen C. Holden. 1986. "The Transition from Wife to Widow: The Importance of Survivor Benefits to the Well-Being of Widows." University of Wisconsin, Institute for Research on Poverty, Discussion Paper no. 806–86, April.

Office of Management and Budget, Executive Office of the President. 1991. *Budget of the United States Government Fiscal Year 1992*. Washington, DC: Government Printing Office.

Peltzman, Sam. 1989. "The Economic Theory of Regulation after a Decade of Deregulation." *Brookings Papers on Economic Activity Micro.*
Securities and Exchange Commission, Office of Economic Analysis. 1991. "Estimating the Value of Federal Deposit Insurance." March.
Sondergeld, Donald. 1989. "Guaranteed Returns: A Tragedy of the Commons." *Journal of Insurance Regulation*, vol. 7, pp. 13–18.
U.S. Department of the Treasury. 1984. *Tax Reform for Fairness, Simplicity and Economic Growth.* Washington, D.C., November.
U.S. Senate. Commerce Committee. 1991. *Hearings on Insurance Company Solvency.* Senate hearings 102–127, esp. testimony of Marty Leary, February 27, and of Thomas Sutton for ACLI, May 9.
Utgoff, Kathleen. 1990. "The Proliferation of Pension Regulations." *Regulation*, Cato Institute, Summer.
Winter, Ralph A. 1981. "On the Rate Structure of the American Life Insurance Market." *Journal of Finance*, vol. 36, March, pp. 81–96.

Discussion

*Joseph M. Belth**

Gerard Brannon's paper is provocative because it discusses a number of controversial topics. I will comment on only one—federal income taxation of the inside interest—although my comments necessarily will touch on other aspects of Brannon's paper. I will break the topic into two parts, the first dealing with cash-value life insurance and the second dealing with the accumulation period in life annuities.

Life Insurance

Life insurance, or what Brannon corrrectly observes should be called "death insurance," performs important functions. It allows an individual to protect dependents against the individual's death when the individual's resources are insufficient to meet his or her objectives for those dependents. Possible illegal methods for handling that insufficiency include robbing a bank, printing money, and insider trading, but life insurance is the only legal method.

Unfortunately, this useful financial arrangement suffers from two related and potentially fatal flaws. Life insurance deals with a subject the individual finds unpleasant—namely, the individual's death. Under these circumstances, the human tendency is to postpone discussion of the individual's needs for life insurance, and therefore to postpone its purchase. Consequently, life insurance must be marketed aggressively.

What I call the anti-procrastination function is performed by life

*Professor of Insurance in the School of Business at Indiana University (Bloomington) and editor of *The Insurance Forum*.

insurance agents. The only effective way to motivate agents to perform that function is to compensate them through substantial commissions, most of which are paid at the time of sale. Without substantial compensation, the anti-procrastination function will not be performed and the amount of life insurance purchased by individuals will be small.

The second potentially fatal flaw is the shape of the curve representing the probabilities of death by age. In the early years, probabilities of death are low. The probabilities increase with advancing age, and in the later years they increase rapidly. Natural premiums for life insurance, therefore, are small in the early years of age, increase with advancing age, and in the later years increase rapidly.

The shape of the curve is a problem for two reasons. First, the low probabilities mean that gross premiums derived from natural premiums tend to be small in the early policy years. Thus, the insurance company does not receive enough premium revenue in the early policy years to compensate agents adequately for performing the anti-procrastination function.

Second, the rapid increase in probabilities of death in the later years produces adverse selection; that is, as gross premiums derived from natural premiums increase rapidly, the relatively healthy members of the insured group tend to drop out, leaving only the relatively unhealthy members still insured. Thus, the quality of the remaining group of insured individuals tends to deteriorate more rapidly than it would from the mere aging of the group.

Level-premium, cash-value life insurance represents an effort to deal with both of these problems. The higher premiums in the early policy years provide the insurance company with more revenue to compensate agents for performing the anti-procrastination function. Also, the level premiums reduce the amount of adverse selection because policyowners are not faced with rapidly increasing premiums.

Level premiums, however, do not solve the underlying problems. When it is suggested that the amount of the agent's commission or the size of the front-end load be disclosed to the consumer, life insurance companies and agents oppose such proposals vigorously. They are probably right when they say such disclosure would be an impediment to the sales process.

Also, level premiums do not level out the price of the life insurance protection. If policyowners were informed of the yearly prices per $1,000 of protection, which tend to increase with advancing age, adverse selection would occur just as it does in the case of gross premiums derived from natural premiums. Proposals to disclose yearly prices per $1,000 of protection are also opposed vigorously by the life insurance industry.

In short, level-premium, cash-value life insurance represents an effort to overcome two potentially fatal flaws. The effort has been

successful because the life insurance industry has been able to avoid disclosing vital information to policyowners and prospective policyowners. In addition, many deceptive sales techniques are widely used, but that subject is beyond the scope of this discussion.

Level premiums give rise to the savings component of life insurance. The federal income taxation of the inside interest in cash-value life insurance is generally deferred until the policy terminates, and then the inside interest is either fully or partially exempt, depending upon the circumstances surrounding termination.

Life Annuities

A life annuity is an arrangement under which the annuitant receives periodic payments, usually monthly, as long as the annuitant lives. The arrangement may or may not involve a minimum number of payments in the event of the annuitant's early death. The idea of a life annuity is to exhaust a principal sum, together with interest, over an individual's lifetime. Brannon correctly describes the arrangement as "insurance against living too long."

Life annuities make sense only when interest rates are low. In that situation, interest payments alone generally do not provide adequate income for the annuitant, and invasion of the principal usually is necessary. The only way to invade the principal and be certain not to exhaust the principal before the annuitant dies is to utilize a life annuity.

When interest rates are high, interest payments on a given amount of principal may be almost as large as life annuity payments derived from the same amount of principal. It makes little sense to use a life annuity that exhausts principal when it is possible to obtain similar interest payments and preserve the principal.

Thus far I have been referring to the liquidation period of a life annuity. A life annuity may have a lengthy accumulation period, either because it is purchased through installment premiums, or because it is purchased with a single premium paid many years before the beginning of the liquidation period.

Federal income taxation of the inside interest during the accumulation period of a life annuity is generally deferred until the annuity is surrendered or until the liquidation period begins. This favorable tax treatment has led to the widespread use of life annuities even where the purchaser has no desire to use the life annuity to liquidate principal and interest over the lifetime of the annuitant. Indeed, life annuities generally are not needed in today's relatively high-interest environment.

Conclusion

The favorable federal income tax treatment of the inside interest in cash-value life insurance and in the accumulation period of life annuities may at one time have been justified, because it was considered socially desirable to encourage the purchase of substantial amounts of life insurance for the financial protection of dependents and the purchase of substantial amounts of life annuities for retirement purposes. It may also have been justified on administrative grounds, because it would have been difficult to establish systems to tax the inside interest currently.

Today these justifications are being weakened. With regard to the social arguments, fewer and fewer individuals are purchasing larger and larger amounts of cash-value life insurance, so that the favorable income tax treatment of the inside interest is increasingly a benefit for individuals with high incomes. As for life annuities, they are being used increasingly by individuals solely because of tax considerations. The administrative arguments against current taxation of the inside interest are also weaker because of modern computer technology.

Two powerful arguments remain for continuing the favorable federal income tax treatment of the inside interest. Although the life insurance companies' share of the savings dollar is declining, life insurance companies remain important financial institutions. I believe that current taxation of the inside interest would have a devastating impact on the life insurance industry and would threaten its very survival. I question whether it would be sound tax and economic policy to take such a step, even though it may be justified on theoretical grounds.

The second argument is purely political. Current taxation of the inside interest is so controversial, and the political power of the life insurance industry is so broadly based, that any elected representative would be committing political suicide to support the idea. I cannot believe that Congress would vote to impose current income taxation on the inside interest, thereby producing a relatively modest amount of revenue, in the face of ferocious opposition by the life insurance industry.

Discussion

*Earl R. Pomeroy**

The insurance regulator's role is a particularly difficult one. An insurance regulator stands in the cross fire of the market economists and portions of the insurance industry who decry regulatory intervention and resulting disruption of free market forces, and consumers and legislators who berate regulators for inactivity whenever circumstances suggest that existing regulatory provisions are not always adequate.

Gerard Brannon has presented a substantive and thought-provoking paper. In particular, I shall comment on the four broad types of governmental intervention in the insurance industry, as outlined in the paper: reserve regulation, consumer protection, solvency guarantees, and tax policy. The concluding section will offer some observations on the existing regulatory structure of the insurance industry in light of the proposal for a new federal role relative to the industry.

Reserve Regulation of Life Insurance

The life insurance industry today has lower capitalization levels, slimmer profit margins, and higher risks on its investment portfolio than it did 10 years ago. These factors have provoked a regulatory response that has improved the sophistication of regulatory oversight, while increasing the breadth of regulatory strictures on the calculation and management of reserves by the life insurance industry. Insurance commissioners increased regulatory intervention in response to the characteristics of the marketplace that have made solvency policing a

*Commissioner of Insurance, State of North Dakota.

significant concern. In this respect, insurance regulation has rejected the economic theory that this financial services industry is best left to its own devices, as companies are ultimately answerable to the undeniable laws of the unfettered free marketplace.

More specifically, regulatory strategies for greater oversight of reserve regulation have included building a greater sophistication into the bond evaluation system used by the Securities Valuation Office while incorporating higher reserve requirements for the lower gradations of bond investments. In addition, the National Association of Insurance Commissioners (NAIC) has recently adopted a model law that imposes restrictions on concentrations of lower-quality bonds. Generally, these restrictions limit "junk bond" holdings to 20 percent of a company's assets, with tighter restrictions specifically applicable to the lowest bond classifications. The Insurance Commissioners are now developing reserve requirements for real estate and other assets, as well as limitations on concentrations of identified higher risk investments.

A consequence of this regulatory activity will be lower investment returns to insurance companies and lower investment returns and higher premium prices to consumers. Another consequence will be the restriction of capital formerly available to certain types of economic activity. In light of the fact that the regulator's highest priority is solvency protection, however, the reserve regulation initiatives are important and wholly appropriate.[1]

Consumer Protection

The initial thrust of regulatory intervention in the marketplace in order to address consumer protection came in requiring certain disclosures to consumers. The rationale underlying this action was that in light of the intangible character of insurance products, consumers were entitled to specific information in order to make prudent choices.

As time has passed, however, the insurance policies offered have grown in complexity while the regulatory structure has grown in sophistication. It has become apparent that regulation aimed merely at informing consumers is not sufficient and more aggressive regulation is required. For many years now, insurance regulation has been directed at dictating minimum product quality for various types of insurance

[1] Further enhancing all of this effort will be improved benchmarks for evaluating the adequacy of insurance company reserves, through the development of risk-based reserving principles. The NAIC activity in this area has been led by Terence Lennon of the New York State Insurance Department, who deserves a great deal of credit for the leadership he has provided to the nation's insurance regulators in this area.

policies. In terms of a free market analysis, this regulatory action restricts consumer choices, albeit for the purpose of ridding the market of consumer alternatives that do not represent a "good buy" under nearly any circumstance.

A case in point is raised in Brannon's paper concerning long-term care insurance. In recent years, regulators have moved to prohibit certain policy limitations that insurance companies have used to limit payment of benefits. While these moves have dramatically improved product quality, they have also increased the claims cost likely to be experienced by the insurance industry on these products. As a result, premium prices have increased.

Many of the health insurance products, including long-term care insurance, face active congressional oversight and intervention. I believe this is especially the case with health insurance over other lines of insurance because health insurance coverage directly involves social policy issues, and Congress has not had sufficient funds to deal directly with the problems arising in health care financing. Some members of Congress seem to go by the maxim, "When one cannot appropriate, the next best thing is to regulate."

Congress tends to be more interventionist in the consumer protection area than insurance regulators, for several reasons. The first is philosophical: while regulators are accustomed to regulating the industry itself, the breadth of congressional legislative authority leaves them much more accustomed to attempting to achieve social goals through the imposition of market restrictions. Perhaps another reason can be attributed to the necessarily more general analysis given to the insurance industry by members of Congress as opposed to insurance regulators. The interplay of market forces may be less clearly understood by legislators, given the infinite variety of issues with which they must deal. An example is again afforded by long-term care insurance. Present congressional proposals would specifically require two features in every policy—inflation protection and nonforfeiture values. While without question these features enhance product quality, requiring their inclusion in each policy sold will dramatically increase premium prices and make this estate protection policy unaffordable to a portion of the market. Another example of the level of intervention Congress is comfortable in mandating can be found in Medicare supplement insurance. In the Omnibus Budget Reconciliation Act of 1990 Congress established a mandate that no more than 10 variations of insurance policies will be allowed in this market (unless a policy is specifically authorized as containing an "innovative benefit").

Solvency Guarantees

Brannon's paper suggests that the costs of solvency guarantees should fall entirely upon the financial services industry that is underwritten. As an individual regulator, I wholeheartedly agree with this assertion. As noted in Brannon's paper, unfortunately this is not the case for the savings and loan industry nor for the banking industry, nor as a general matter is it true for the life insurance industry. Most of the states with life and health guaranty funds offer a tax credit that effectively reduces an insurance company's premium tax obligation to a state by the amount of assessments it pays into the guaranty fund. Accordingly, in reality, life guaranty funds ultimately represent a state taxpayer assessment, not an insurance company assessment.

Brannon correctly asserts a marketplace danger of guaranty funds. By guaranteeing all policies, market forces encouraging sound solvency management practices—including high capitalization and low-risk products—compare unfavorably to higher-risk products written by companies having thin levels of capitalization.

While regulators acknowledge that solvency guarantees through insurance guaranty funds may have the effect of dulling consumer sensitivity in this area, clearly guaranty funds serve a critical role in the insurance market today. Regulators have tried to minimize the downside consequences of guaranty funds by restricting agents from touting the existence of the insurance guaranty funds while soliciting the sale of insurance products. In North Dakota, for example, an agent may not discuss the guaranty fund until notification is provided with the delivery of the insurance policy—well after the application has been submitted to the insurance company.

An issue exists today as to whether guaranty funds will have adequate capacity to cover policyholder obligations in light of either the failure of an extremely large life insurer or in the event of a rash of several life insurance insolvencies. Guaranty fund capacity is determined by an assessment limitation, based upon the amount of premiums written by insurance companies in a state in a given year (usually 2 percent of premium writings). In light of recent hearings the NAIC has held on this subject, I am reasonably hopeful that the guaranty fund mechanism does have sufficient capacity on a state-by-state basis, even in light of the regulatory action taken against Executive Life Insurance Company.

In this specific instance, I commend Commissioner John Garamendi of California for his careful handling to date of this terribly complex insolvency. In the event a course of liquidation had immediately been embarked upon, given the virtually illiquid condition of many of the junk bond assets held in the Executive Life investment portfolio, a significant shortfall would have resulted that probably would have

exceeded the reach of the insurance guaranty fund. I am hopeful the course the California Insurance Department has set upon, including the solicitation of contributions from other interested parties, will provide the policyholders with substantially the benefits of their contracts, without busting guaranty fund capacity throughout the country.

Tax Policy

Expertise as an insurance regulator has not afforded me particular expertise regarding the tax policy issues presented by the current insurance industry tax structure. However, I have some general observations.

First, Brannon's paper offers useful comments on the significant tax subsidy now provided in support of the present employer-based health insurance system. While this policy has historically been extremely successful at obtaining insurance coverage for most Americans through employer-based health insurance plans, obviously further governmental intervention will be required in the not-so-distant future, in light of the chronic difficulties of crisis proportions now existing in this line of insurance. The significant tax subsidy that has been available for employer-based health insurance would seem to provide considerable basis for additional government initiatives, aimed at cost and coverage issues, in the employer-based health insurance system.

A second issue on tax policy involves solvency. Dramatic changes in tax policy have the potential to cause significant consequences in the insurance marketplace. It is likely that aggressive tax policy changes would have a detrimental impact on company surplus positions and could cause difficulty to the most thinly capitalized companies. I do not offer this as a reason not to address inequities in the present tax structure, but rather as a word of caution. Significant changes in tax policy should be implemented on a phased-in basis after ample notice and lead time have been afforded, in order to avoid causing failures of insurance companies that have not had a chance to prepare for these changes.

Implicit Strengths in the Existing Regulatory Structure

State insurance regulation came into being in the mid 1800s when the character of the insurance industry was quite different and federal government activity significantly more limited. However, this does not mean that the existing structure is irrelevant to the challenges of regulating today's insurance industry.

State insurance regulation has had an evolutionary character which,

generally speaking, has allowed states to successfully perform their regulatory responsibilities. For example, recognizing the need for interstate coordination of insurance regulatory activities, the Insurance Commissioners formed the National Association of Insurance Commissioners in 1871. Four years later they developed the forerunner of a uniform financial statement that provides for uniform insurance accounting methods for all companies, regardless of their state of domicile. In 1909, they established the Securities Valuation Office for the purpose of implementing a uniform valuation of bonds held by insurance companies. In the 1930s, multistate financial examinations were begun in recognition of the fact that companies were often doing business across state lines. In the 1970s, the NAIC established a series of solvency evaluation tests which were run on the financial statements of all companies filing with the NAIC.

The state regulatory system has undertaken more dramatic steps in recent years to stay abreast of an industry that has grown significantly more complex over the past 10 to 15 years. Nationwide regulatory changes have been implemented through the use of four strategies, based upon unique attributes of the existing regulatory structure.

First, additional requirements have been added to the financial statements required of all insurance companies. Actuarial verification of loss reserves and CPA audits were implemented throughout the regulatory system by incorporating these requirements into the Annual Statements in 1990.

Secondly, the NAIC presently has an annual budget in excess of $15 million and a staff of 155 for the purpose of supporting the more than 8,100 men and women involved in insurance regulation throughout the state insurance departments. The staff and budget have more than doubled since 1987, reflecting general recognition that greater support services from the NAIC would be an important aspect of improving the regulation of this industry.

Thirdly, regulators have implemented a system of peer review, wherein the performance of departments vis-à-vis financially troubled companies is monitored and evaluated on an ongoing basis. In the event a domestic state refuses to take required action on a financially troubled company, other state regulators are prepared to initiate the activities required for the protection of policyholders throughout the nation.

Finally, and most importantly, the NAIC has taken the historic step of adopting minimum standards for the regulation of solvency. The standards were enacted in 1989, and in 1990 an audit mechanism was established for the purpose of verifying state compliance with the minimum standards. To date, four states have passed an audit review and have been certified. States have a particularly strong incentive to obtain certified status, in light of the additional regulatory requirements that will apply to domestic companies of noncertified states, beginning

in 1994. States not meeting compliance standards may face the prospect of the redomestication of their insurance companies, because of the imposition of further regulatory burdens on their companies' ability to transact interstate business. This incentive to obtain certification appears to have been very successful during the 1991 legislative cycle. To date, 45 states have been identified as including in their legislative proposals the solvency regulatory bills required to obtain certification.

The U.S. insurance industry is extremely competitive, and this has resulted in relatively extensive insurance regulation. Without question, the United States has more insurance regulators per company than any other country. The insolvencies occurring within the existing industry structure are due in part to the intense competition in price and product quality. While regulators and policymakers alike recognize the need to reduce the number of insolvencies now and in the future, it is unlikely that consumers will stand for significantly higher prices in order to provide sufficient return to insurance companies to ensure that insolvencies will not occur.

Downside Consequences of Dramatic Federal Regulatory Intervention

Insurance regulators have significant concerns regarding the future of the insurance market in the event that sweeping new federal regulatory proposals are passed by this Congress. Some of the reasons for their concern are as follows.

First, the federal perception of the solvency problem appears to be overstated. The intense level of current federal interest seems to be driven in part by the extreme sensitivity concerning solvency caused by the substantial number of savings and loan failures, as well as a perception that the financial difficulty experienced by the Executive Life Insurance Company may represent a harbinger of things to come within the life insurance industry. In point of fact, economic analysis of the three financial services industries reveals that insurance is substantially different from the thrift and banking industries and is in considerably better financial health. In addition, while Executive Life became financially imperiled in light of its reliance upon junk bonds in its investment portfolio (69 percent of its assets were junk bonds, prior to the action taken by the California Insurance Department), the life insurance industry as a whole has followed a much more conservative investment pattern. On average, only 6 percent of the assets of the insurance industry are junk bonds.

Second, reforms of the existing structure have not been given enough time to work. The activity of state insurance regulators in improving oversight regarding solvency is without precedent within the

state regulatory system. These reforms should be objectively assessed as to whether they have sufficiently addressed the new complexities of the insurance market. Obviously, it will be cheaper, quicker, and more cost efficient to enhance the present regulatory structure than to scrap it for a new and unproved system with close analogies to failed regulatory systems. The dual regulatory structure has been recognized as playing a prominent role in the widespread failures realized within the thrift industry, for example.

Third, the market consequences of a federal regulatory structure may adversely affect the insurance industry. The analysis to date of the state regulatory system has had a tendency to note every insolvency as a significant regulatory failure. Under this analysis, regulators are seemingly being held to a standard of perfection. State regulators would be the first to acknowledge that the existing structure is not perfect and that failures will occur within the present state regulatory format. On the other hand, however, the existing structure, with the expertise, resources, and existing authority all located at the state level, represents a regulatory system that will compare favorably with any federal proposal.

Any viable federal proposal must be developed according to the laws of least political resistance. One can anticipate that these laws will have the following consequences.

First, state rate regulation will not be preempted. In light of the political activity taking place at the state level relative to rate regulation, driven by the affordability crisis in private passenger auto and health insurance, state governments would vigorously oppose preemption of rate regulatory authority. Any member of Congress from a large urban district is unlikely to vote to remove from the state regulatory system the ability to evaluate and control premium rates.

Accordingly, the industry faces the prospect of federal solvency regulation while rate regulation continues at the state level. Over the long haul, it would be untenable to separate rate regulation and solvency regulation, in light of the inextricable relationship between adequate rates and financial solvency. Having a regulatory system not charged with the complete responsibility would increase the likelihood that an affordability crisis driven by soaring claims costs would result in the suppression of premium rates below levels required to maintain financially strong companies.

Second, it is easier to add than to preempt. Accordingly, a new federal regulatory oversight role would likely come in addition to the existing regulatory responsibilities of the states. Portions of the insurance industry looking favorably on federal regulation as a means to avoid state regulation may find themselves sorely disappointed to find more regulatory requirements, not less, as a consequence of some new federal role. As mentioned earlier, dual regulatory structures have not

proven to be the end-all of solvency regulation, as evidenced by the other financial services industries. Insurance premium tax revenues are critical to the budgets of state governments, which have assumed ever greater responsibilities in recent years. I believe states would fight to the death any proposal to preempt state premium tax collection.

Third, it is also inevitable that any new federal role be financed entirely by the insurance industry. Given the federal budget deficit, any federal initiative must pay its own way, and that would particularly be the case in a regulatory undertaking of the insurance industry. Administrative costs to companies would increase in order to pay for any additional regulatory functions.

Fourth, regulation driven by a federal system is more subject to political manipulation nationwide than a state-by-state regulatory system. As evidenced by the significant changes in regulatory philosophies between recent Administrations, philosophical swings can be extremely disruptive to the functioning of a financial services industry.

Conclusion

In conclusion, I believe the debate on insurance regulation will represent a ball game with two halves. In the first half, the state regulatory structure is competing against the concept of a perfect regulatory system. Implicit in some of the searing criticism received to date is the idea that a perfect structure would not have allowed these regulatory lapses and that a federal response would be in the nature of establishing a perfect structure. In the second half of this ball game, the existing regulatory system will be competing against an actual federal proposal. I expect that the evaluation of the existing system will be much more favorable when contrasted with a concrete federal alternative constructed along the aforesaid principles of least political resistance.

Discussion

*Warren R. Wise**

Gerard Brannon presents some interesting points in his paper, "Public Policy and Life Insurance." In response, I will comment first on his point that life insurance combines death protection and investment of the insured's savings. I will then address, somewhat more extensively, his comments regarding the solvency problem now facing the life insurance industry.

Policy Values

Brannon asserts that the cash value resulting from premiums paid on permanent life insurance is equivalent to a savings account. He denies that it is related to the protection provided by the policy. This analysis is not entirely accurate and leads to some faulty conclusions.

The cash value accumulation in a life policy results from the leveling of the total premium over the anticipated term of the insurance protection. Without this leveling, the premium in the later years would be excessive. Leveling involves a modest prepayment of premiums needed to support coverage in later years. The resulting cash value in the policy is not a savings plan. It is simply the means of providing lifetime protection at an acceptable price.

The assertion that permanent insurance involves a savings plan leads to several questionable conclusions. For example, it is erroneous to conclude that permanent insurance includes savings because the federal

*Executive Vice President and General Counsel, Massachusetts Mutual Life Insurance Company.

tax on these savings is less than the tax on other kinds of savings. As explained, the cash value exists to help meet insurance costs in later years. It does not exist because of the applicable tax treatment. In fact, cash value life insurance existed long before the enactment of our federal income tax law.

It also is erroneous to conclude that the tax-free inside buildup in life insurance is a tax subsidy to savings and not a subsidy to encourage the purchase of life insurance protection. The cash value is integral to the death protection provided by the permanent whole life policy. Congress gave tax-free status to the interest added to the cash value to encourage Americans to provide adequate protection against untimely death. The tax-free status for this interest is not intended as a stimulus to enhanced savings.

The tax-free status of the interest added to the cash value on a permanent life insurance policy also is consistent with the legal doctrine of constructive receipt. Under that doctrine, income is not taxed if the taxpayer would have to incur a substantial detriment to realize the income. The constructive receipt doctrine applies to interest on cash values because the policyholder would have to give up the policy or incur some other substantial detriment to realize the interest added to the cash value. The policyholder cannot obtain a comparable policy without paying a new front-end sales load. If uninsurable, the policyholder may not be able to obtain new insurance at all. These are substantial detriments. Congress also granted tax-free status for the interest added to the cash value in a permanent life insurance policy because it did not want to impose a tax on income saved instead of consumed.

Before I discuss the solvency problem, I want to commend Brannon for making two very important points.

Some criticize the life insurance industry because they believe the tax-free treatment for interest added to the cash value in a life insurance policy is an unnecessary tax subsidy. Brannon points out that other financial institutions receive even greater subsidies from the federal government. He notes, for example, the substantial subsidy given to banks and thrift institutions through the federal deposit insurance program.

Brannon also makes a telling point regarding the dramatic decline in the amount of assets committed to life insurance. The insurance industry should take note of this. The trend also is significant beyond the insurance industry, because traditionally life insurers have been a major source of long-term investment capital for our economy.

The Solvency Problem

Now I would like to discuss the life insurance solvency problem. Brannon asserts that solvency is a significant problem in the life insurance industry today, and I agree.

The Problem

The record shows clearly that the number of life insurance companies becoming insolvent has increased significantly over the last few years. In the 16-year period from 1975 through June 1990, 168 life insurance companies became insolvent or impaired. From 1975 through 1982, insolvencies averaged five per year; from 1983 through 1989, the average rose to 17 per year. In 1989, 43 insolvencies occurred, the most in any year. Between 1975 and 1989, assessments to guaranty funds totaled $485 million. Costs rose from $62.4 million in 1988 to $160 million in 1989.

This trend is continuing. In 1990, over 25 percent of all life insurance companies had four or more financial ratios outside the usual ranges. Companies like these have historically been designated by the National Association of Insurance Commissioners (NAIC) for immediate regulatory attention.

The change in the size of the companies becoming insolvent also is significant. Not long ago most insolvent companies were small and had only a few policyholders. Now we face the problems that arise when major companies like First Executive and First Capital become impaired. We also face the financial problems surrounding an insurer like Monarch right here in Massachusetts.

The life insurance industry offers a unique product. It receives money from customers today in return for an intangible promise to pay benefits at some future date. The value of the promise depends entirely upon the insurer's ability to pay. The solvency problem is truly serious if the consumer's financial needs are not met because the insurer fails to meet its obligations. This is true no matter what the size of the insurer may be. It is not an acceptable answer to say, as some do, but not Brannon, that on the average only a few companies become insolvent and the amount involved is comparatively insignificant. We must focus on the plight of the insurance consumer who buys insurance but fails to receive the promised insurance benefit.

As Brannon observes, the high interest rate environment of the late 1970s and early 1980s triggered a product revolution in the life insurance industry. As a result, the industry is more competitive than it was 10 years ago. Profit margins have declined. Capital and surplus levels have declined. Companies that could comfortably ride out bad times, like the current slump in the real estate market, are now at greater risk because

the liability side of the balance sheet has changed. Today life insurance companies offer more investment-oriented products, such as single-premium life, universal life, and guaranteed investment contracts, as well as traditional products with higher cash surrender values like participating whole life insurance. In order to offer higher returns, some insurers are taking more risks on the asset side of the balance sheet as well. As a consequence, the industry is more vulnerable to failure than it once was.

The product innovations in the life insurance industry over the past several years could result in an abuse of the solvency system. But, as I will discuss later, controlling possible abuse is feasible. It can be done without denying protection for the values associated with these policies.

Brannon's Solvency Suggestions

Brannon and I agree that today solvency is a major problem in the life insurance industry. We do not agree about the solution to the problem.

Brannon suggests that solvency protection provided for insurance consumers should be limited to the death benefit provided by the policy. He asserts that the protection should not extend to the cash value or "savings" associated with the policy. Clearly, Brannon goes too far in suggesting that solvency protection should be denied to the cash value in any life insurance policy. Solvency protection should be provided to all persons who buy life insurance and whose quality of life would be imperiled by the failure of their insurer to fulfill its promises. The loss of the protection afforded by a permanent life policy or a universal life policy, both of which have cash value, is just as devastating to a consumer (especially one who has become uninsurable) as the loss of the protection provided by a term policy that does not have cash value. Any "solution" to the solvency problem that does not cover assets is probably unworkable and is certainly incomplete.

For these reasons I believe Brannon's suggestions regarding how the solvency problem might be solved miss their mark. Before offering my suggestions regarding how the industry could approach the solvency problem, I want to discuss several fundamental principles that should be included in any solution to the solvency problem.

Principles regarding Solvency Solution

Any solution to the solvency problem must protect the interests of the insurance consumer. It would not be acceptable simply to protect life insurance "insiders," such as industry executives, sales representatives, state insurance regulators, or any federal regulators.

In addition, all the interested parties should be required to make a contribution toward the cost resulting from the insolvency of a company. The contributors should include all life insurance companies, including the insolvent company, life insurance sales representatives, state insurance regulators, and all life insurance consumers affected by the insolvency. The present system, which unfairly requires that only financially successful life insurance companies cover the cost of an insolvency, must be abandoned.

Improved Regulations

The regulations that help prevent insurance companies from becoming insolvent must be improved to meet the solvency problem. Specifically, life insurance companies must be required to meet risk-based capital and surplus requirements. In other words, a company should maintain high investment reserves if it follows a high-risk, high-yield investment strategy. A company also needs to maintain high reserves where liquidity is lacking or where the company does not match assets and liabilities.

Reserve requirements should also be strengthened, and the opinion of a valuation actuary should be required on asset–liability matching. Prudent insurers that write investment-oriented business have been matching assets and liabilities since the early 1980s. New York State law requires matching. All states should require it.

Investment restrictions should be strengthened. Insurance regulations must take into account the growing dependence by the industry on investments other than stocks and bonds, such as junk bonds and commercial mortgages.

Accounting practices should be improved, as should audit and examination practices. Controls over reinsurance transactions should be strengthened. Perhaps most important, insurance regulators should have sufficient resources to do a good job. In the past, state insurance departments have not had the resources they need. This situation has been worsened by the recent fiscal crises faced by many states, including Massachusetts.

Guaranty Fund Improvements

Guaranty funds maintained by any government for the benefit of life insurance consumers need improvement to meet the solvency problem. Every life insurance company that becomes insolvent places a heavy financial burden on well-managed insurers to make good on the promises made by the insolvent company to its policyholders. In effect, well-managed life insurance companies pay twice—once when they lose business to companies that make unrealistic promises and later become

insolvent, and a second time when they are assessed by guaranty funds to pay for the insolvent companies' promises.

Today the insurance industry sustains guaranty funds by assessments on solvent companies. In other words, when an insolvency occurs, state guaranty funds raise the money needed to cover losses by an assessment on solvent companies. It would be better to fund the insolvency by advance assessments on all life insurers. By doing so, even insurers that ultimately become insolvent would contribute toward the costs arising from the insolvency.

The amount assessed in advance should be determined on a risk-adjusted basis. It seems reasonable that companies creating the greatest risk should be required to make the largest contributions to the guaranty funds. To make this plan effective, insurance regulators should select the factors that will show the degree of risk involved in each company. They also should make advance assessments based on their determination of the risk created by each individual insurance company.

As mentioned above, four groups should pay for the cost of insolvencies: other insurance companies, insurance sales representatives, the government, and insurance consumers. Insurance companies should help pay for the cost of insolvencies because they have a self-interest in maintaining the reputation of the industry. Life insurance sales representatives should be required to contribute to the guaranty fund maintained for the benefit of their clients. Insurance consumers rely on the advice they receive from their sales representatives. If the representative is financially at risk, the representative will be more likely to sell insurance written by a financially secure insurer. Contributions could be obtained from sales representatives by requiring that they contribute to the guaranty fund before they can obtain their license to sell insurance.

State insurance regulators should also be required to contribute to the cost resulting from an insolvency involving insured persons living in their state. This requirement should be imposed because the cost incurred would give the state a strong incentive to regulate vigorously to prevent insolvencies. The contribution from the state could be obtained by permitting insurance companies to offset their guaranty fund contributions against their state premium tax liability. Many states already permit this.

Insurance consumers also should bear part of the cost if the company they select later becomes insolvent. This could be done easily by limiting the amount of their recovery to a portion of their loss. For example, under California's new law, insured persons can recover only 80 percent of their claim. Forcing consumers to bear a portion of their loss might encourage them to investigate carefully before they choose their insurer. This might help reduce the financial burden resulting from the insolvency of insurers.

Who Should Administer the Solvency System?

These are the principles needed for an effective solution to the solvency problem. But who should be responsible for administering the solution? Two ways to deal with the solvency problem are being considered. One involves strengthening state regulation of the solvency of the life insurance industry. The other involves federal oversight of life insurance industry solvency matters.

Many responsible persons in the life insurance industry believe the best approach is to strengthen state regulation of solvency. They believe that the NAIC should develop model laws and regulations for this purpose to be adopted by the states. This process is already underway. Leaders in the NAIC, like Commissioner Earl R. Pomeroy, have taken the initiative in this effort, which the life insurance industry supports.

A successful NAIC effort will meet the needs of insurance consumers and it will preserve the existing scheme of insurance regulation. But the important question is "Will the effort succeed?" Will all the states adopt the NAIC model laws? If the states do act, will they do so without making meaningful changes in the NAIC model laws? And will all the states have all the resources needed to regulate effectively under the new system?

These are troublesome questions. The problem today is bad enough! It will be infinitely worse if the industry—its leaders, its sales representatives, and its regulators—promises a solution and then fails to deliver it.

Some thoughtful leaders in the industry and some representatives in Congress suggest federal oversight of life insurance solvency as another solution. This approach would use a federal "lever" to promote a uniform, minimally competent level of state regulation, but would otherwise minimize federal involvement in insurance regulation.

To obtain this result, Congress could simply enact a law setting forth: (1) specific and uniform solvency standards; (2) specific guaranty fund provisions; and (3) minimum financial resource and competency standards for state insurance departments. The federal law would further provide that these provisions should be adopted by the states within a stated period, say two years. Adoption of these provisions by the states would be a condition for continuation of the privilege given insurers under the McCarran-Ferguson Act to sell insurance in interstate commerce, while also being regulated by the states and not by the federal government.

The federal law also should provide that, if an individual state fails to enact a timely law adopting the federal solvency standards, insurance companies domiciled in that state would be prohibited from selling insurance in interstate commerce outside that state. To give relief to these companies, the law could further provide that companies domi-

ciled in such a state would be allowed to sell insurance outside their state of domicile if they agree to be bound by the laws of any other state that had adopted the federal solvency standards.

This federal oversight approach is an attempt to preserve the traditional role of the states in regulating life insurance activities, and particularly solvency, while also ensuring that the provisions to protect insurance consumers from solvency losses are adopted uniformly and are applied effectively throughout the country.

Which approach should we support? A successful effort to improve state regulation is most desirable. The efforts of the NAIC and individual state commissioners to improve state regulation are commendable. On the other hand, the General Accounting Office recently studied this effort carefully and concluded that it will not succeed, even though it is highly laudable. The reason given: the NAIC does not have the jurisdictional clout to obtain the desired result.

If the effort to improve state regulation fails, we should all support federal solvency standards and federal oversight of solvency through a system like the one I have described. The life insurance industry serves an important need of its customers and, more broadly speaking, an important need of our society. We have a duty and an ethical obligation to meet our responsibilities to our policyholders. The solvency problem must be solved, and it will be. If it can be solved at the state level, fine. But, if federal intervention is necessary to obtain an effective solution, the industry should accept the federal role because a solution to the solvency problem is "the right thing to do."