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STATEMENT OF

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GENERAL GOVERNMENT DIVISION

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

COMMITTEE ON WAYS AND MEANS

HOUSE OF REPRESENTATIVES

ON

PROFITABILITY OF THE PROPERTY/CASUALTY INSURANCE INDUSTRY

Mr. Chairman and Members of the Subcommittee:

We are pleased to appear before the Subcommittee again to assist it in its deliberations on the subject of the insurance industry. At your request, we will address our remarks today to (1) the property/casualty industry's pricing strategies, particularly as they are affected by "cash flow underwriting"; (2) industry profitability; (3) the cyclical nature of that profitability; (4) the financial outlook for the industry; and (5) the current difficulties in the property/casualty industry, specifically as they relate to the medical malpractice and general liability insurance lines.

In addressing these issues, we will make the following points. Property/casualty companies have used a pricing strategy which sacrificed underwriting profit margins in order to generate cash for investment purposes. As a result of this strategy, the property/casualty industry has made, depending upon whose estimates are used, between $50 and $75 billion in net gains over the last 10 years. Furthermore, like many other businesses, property/casualty underwriting is subject to profitability cycles. While underwriting losses have mounted since 1980, estimated data for 1985 indicates that the underwriting cycle has turned and is now moving in a positive direction. Indeed, the industry itself is projecting substantial net gains over the next 5 years.

The current difficulties in liability insurance are found principally in certain liability insurance lines. Two lines frequently mentioned by the media within a crisis context are general liability and medical malpractice. These lines, however, represent a small portion, less than 10 percent, of the total property/casualty business. Furthermore, as compared to some reported premium increases, our computations show that, with smaller increases in earned premium revenues, these lines could break even.

I will now discuss these points in greater detail. In doing so, I will explain the sources of our data and the scope of our work.

PROPERTY/CASUALTY COMPANY PRICING STRATEGIES

A property/casualty company derives its income from two principal areas: underwriting gains, which are the excess of premiums over claims and expenses, and investment gains. Because of investment gains, a property/casualty company can have net income even though its premium revenues alone are not large enough to cover claims and expenses.

Thus, the ability to offset underwriting losses with investment income plays an important role in a company's pricing strategy--that is, the amount it charges for the insurance that it offers. For a number of years, many companies have employed a pricing strategy known as cash flow underwriting. Basically,

companies have been willing to accept lower premiums for certain insurance lines in order to encourage sales and obtain funds for investment. In essence, the strategy has been to sacrifice underwriting gains for investment gains. For example, in 1984, claims, expenses, and policyholder dividends exceeded premium revenues by almost 18 percent.

The companies, however, have taken this risk because they expected to make up the premium shortfall through investment income. Through the increased volume of premiums resulting from this pricing approach, companies were able to generate a larger amount of net cash flow which they could then invest to earn additional investment income. For instance, over the 5-year period 1980-1984, when the industry's claims and expenses exceeded premiums by about 9 percent, its underwriting loss was about $45 billion. Even so, the industry had $82 billion in investment gain which, when offset against its underwriting losses, resulted in a net gain of about $37 billion. The investment gain was made possible, at least in part, by the industry's pricing strategy which generated about $66 billion in net cash flow. The industry was then able to invest these funds at favorable rates.

From 1975 to 1983, investment gains, in the aggregate, have exceeded underwriting losses by a fairly wide margin. However, this situation changed in 1984, when underwriting losses for the industry were $19.4 billion while investment gains were $17.9 billion. Reacting to this result, some companies have sharply raised premiums.

PROFITABILITY OF THE PROPERTY/CASUALTY INDUSTRY

We developed a financial overview of the property/casualty insurance industry using financial data for the 10-year period 1976 through 1985. We obtained the 1976-1984 data from Best's Aggregates and Averages and the 1985 data from Best's Insurance Management Reports, dated December 30, 1985. The 1985 data were estimated by Best's since final 1985 operating results were not, and are still not, available. While Best's reports omit figures for many small or new companies, we believe that the data are representative of the overall financial results of the property/casualty industry.

In the table below, we show sources of property/casualty income broken out by underwriting gains, investment gains, and total gains. This table clearly illustrates the results of the industry's pricing strategy to obtain investment income at the expense of underwriting income. While property/casualty companies had about $65 billion in underwriting losses, they also earned about $140 billion from their investments during this 10-year period. Overall, the industry had a net gain of about $75 billion.

All Companies -- Consolidated Basis
1976 through 1985
($ in billions)

Underwriting gains/(losses)	Investment gains	Net gains
($65.2)	$140.2	$75.0

We would like to make two points about our figures which may differentiate them from figures developed by others. First, the investment gains include net investment income and both realized and unrealized capital gains. We recognize that unrealized gains are just that, unrealized, and therefore, are subject to investment risks which could result in lower or higher amounts. However, we have chosen to include unrealized gains in our figure because it is within a company's control to manage its investment portfolio so as to realize these gains while the investments are profitable.

Second, the underwriting losses do not reflect policyholder dividends. We consider these dividends to be voluntary, not mandatory, distributions by the companies. Since the companies are not required to make these distributions, we have chosen to exclude them from our underwriting loss figure.

Even if we adjusted our figures to exclude unrealized gains and to include policyholder dividends (the approach used by the industry for its calculation), the industry's net gain for this 10-year period would still be $51 billion. In either case, it is within management's discretion to realize investment gains or to not pay policyholders' dividends.

CYCLICAL NATURE OF INDUSTRY PROFITABILITY

While it is important to look at the figures for the most recent years, it should be noted that over the longer period the property/casualty industry has demonstrated profit and loss cycles. We believe that data covering longer periods give a more complete picture of the industry's profitability.

Unlike most other industries, the property/casualty insurance industry is flexible with respect to capacity or supply. During profitable periods insurance companies can increase their capacity, take varied and greater risks, and generally lower their premium rates to achieve a greater market share. Such actions result in price competition as other firms lower their prices to retain their market share. Price competition results in a change from favorable premium profit margins to unfavorable margins, resulting in the underwriting profit and loss cycles.

Attachments I and II illustrate the cyclical nature of the property/casualty industry profitability. Attachment I shows the year-by-year underwriting and investment results for the 12-year period from 1974 through 1985. Column 2 in that attachment, underwriting gains and losses, illustrates the cyclical nature of the industry. The earlier cycle bottomed out in 1975 with a $3.65 billion loss and peaked in 1978 with a $2.55 billion gain. Since 1980, underwriting losses have mounted again. However, estimates indicate that the loss cycle bottomed out in 1985 and that the cycle has now turned upward.

Attachment II illustrates the cyclical nature of property/casualty stock companies over the past 40 years. For purposes of illustration, we used the combined ratio concept, a ratio of claims and expenses to premium income. The attachment reflects the industry's underwriting results and premium pricing strategy; it does not include investment results. As can be seen, stock companies have had several underwriting cycles since 1945.

FINANCIAL OUTLOOK FOR THE INDUSTRY APPEARS FAVORABLE

From all indications, it appears that the trend towards larger underwriting losses has peaked. Available industry estimates show that over the next 5 years the industry expects substantial net gains. Our calculations, made from the industry estimates, indicate an expected net gain before taxes of more than $90 billion over the years 1986-1990.

Analysts of the industry also generally predict favorable industry prospects. For example, an August 1985 study by Salomon Brothers, Inc.,[1] forecast that premiums written will grow at a 12 percent annual rate over the 1985-1989 period. The same study forecasts a 10 percent growth rate for incurred losses over the period. The study forecasts further that total industry profits will rise annually at a rate of 25 percent over the same period. More recently, the Best's Insurance Management

[1]Salomon Brothers, Inc., Property/Casualty Insurance Organizations, Five-Year Review and Outlook, 1985 edition, August 1985.

Reports, dated December 30, 1985, estimated that net premiums written in 1985 would increase by 21 percent over net premiums written in 1984.

PROBLEMS IN MEDICAL MALPRACTICE AND GENERAL LIABILITY LINES

Although the financial outlook for the industry as a whole appears favorable, the current difficulties in liability insurance are more pronounced in certain lines. Two insurance lines often mentioned in the context of high premiums and lack of availability are medical malpractice and general liability. General liability insurance includes coverage of items like day care centers, asbestos removal, and municipalities. The following examples are illustrative of some reported difficulties individuals and businesses have encountered recently:

--In February, the government's interagency Tort Policy Working Group reported on a survey of day care providers which found that insurance policies had been cancelled or not renewed for 40 percent of the respondents and the majority of those with continuing coverage had experienced premium increases of between 200 and 300 percent.

--In March, the American Medical Association testified before this Subcommittee that malpractice insurance rates for obstetricians in Maryland increased by 130 percent last summer.

--The March 24, 1986, issue of Time reported the story of one asbestos removal company whose policy increased in cost from $9,361 to over $450,000, an increase of almost 5,000 percent, despite never having been sued.

The medical malpractice and general liability lines, however, do not represent a major portion of the total property/casualty insurance business. Attachment III shows, for 1985, the relationship of these two lines to other property/casualty lines. The data were estimated by Best's which reports on 27 insurance line categories. For our purposes, we have grouped certain lines into one category; for example, personal and commercial automobile liability is shown as automobile liability.

The figures in this attachment show that the medical malpractice and general liability lines represent a relatively small portion of the industry. Medical malpractice premiums accounted for less than 2 percent of all property/casualty premiums written for 1985 and general liability premiums accounted for less than 8 percent. However, underwriting losses attributable to these lines accounted for almost a quarter of

all underwriting losses; medical malpractice being 5.6 percent and general liability being 18.3 percent. It should be noted, Mr. Chairman, that for certain companies that specialize in these liability lines, the proportion of the losses will likely be higher.

Despite the relatively large proportion of underwriting losses that the medical malpractice and general liability lines represent, attachments IV and V show that in 1984 these two lines could have broken even with smaller increases in premium rates than the rate increases presently being reported in the media. Attachment IV, for example, shows that for the medical malpractice line, a premium rate increase of 20 percent would have put this line at a break even point. Similarly, attachment V shows that for the general liability line, an approximate 30 percent increase in premium rates would have been sufficient to break even. (1984 is the most recent year for which we are able to make such estimates; the necessary data is not yet available for 1985.)

CONCLUSION

In conclusion, Mr. Chairman, available financial information for a recent 10-year period indicates that the profitability of the property/casualty industry has been cyclical in nature. The data further indicate that over this period the industry has been generally profitable. The industry's profitability has been lower in recent years;

however, the industry projects increasing premium volumes and more favorable prospects for the next few years. The data also show that while medical malpractice and general liability insurance have received considerable attention recently, they represent a relatively small portion of the industry overall. Finally, our calculations show that, for 1984, these lines could have broken even with smaller increases in premium rates than some premium rate increases currently being reported in the media.

That concludes my statement, Mr. Chairman. We would be pleased to respond to questions.

ATTACHMENT I

UNDERWRITING GAINS, INVESTMENT GAINS, COMBINED UNDERWRITING AND INVESTMENT GAINS: ALL COMPANIES -- CONSOLIDATED BASIS[a] YEARLY 1974-1985

($ in millions)

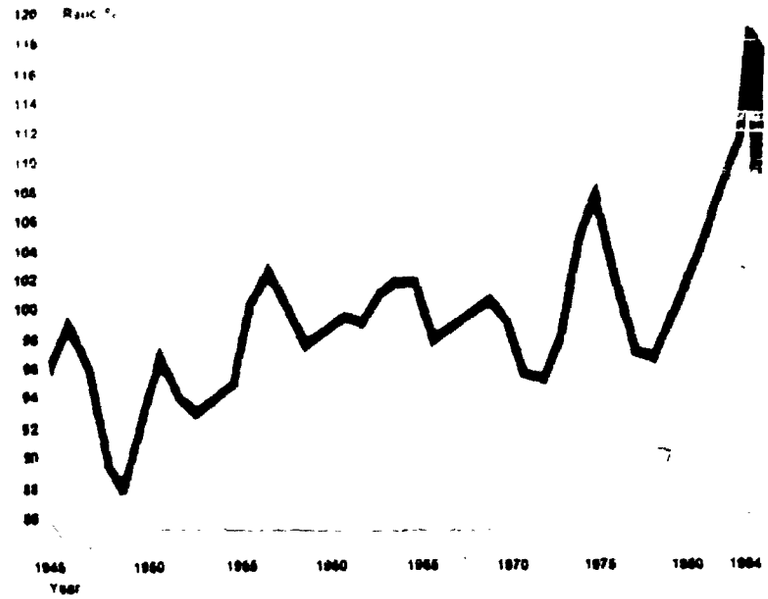
Year	Underwriting gains/(losses)	Investment gains/(losses)	Total
1974	(1,974)	(2,443)	(4,417)
1975	(3,653)	7,009	3,356
1976	(1,726)	7,173	5,447
1977	1,926	5,063	6,989
1978	2,548	7,758	10,306
1979	24	11,610	11,634
1980	(1,712)	15,870	14,158
1981	(4,464)	10,858	6,394
1982	(8,303)	18,387	10,084
1983	(11,088)	19,441	8,353
1984	(19,379)	17,875	(1,504)
1985 Est.	(23,100)	26,200	3,100

[a]Consolidated totals eliminate double counting by excluding intercompany transactions between parent and subsidiary companies.

ATTACHMENT II

ATTACHMENT II

Combined Underwriting Ratios for Property/Casualty Stock Companies for the Years 1945-84[a]



Year	Ratio %	Year	Ratio %
1945	95.8	1965	101.9
1946	98.8	1966	98.1
1947	96.3	1967	98.9
1948	91.2	1968	100.0
1949	87.6	1969	100.6
1950	93.0	1970	99.3
1951	97.1	1971	95.8
1952	94.4	1972	95.4
1953	93.1	1973	98.2
1954	93.6	1974	105.0
1955	94.9	1975	107.5
1956	100.5	1976	102.0
1957	102.9	1977	97.0
1958	100.0	1978	96.6
1959	97.8	1979	99.6
1960	99.4	1980	102.4
1961	99.4	1981	104.9
1962	99.0	1982	108.7
1963	101.0	1983	111.8
1964	101.9	1984	119.0

[a]A combined ratio is a ratio of claims and expenses to premium income. Ratios below 100 represent underwriting gains and ratios above 100 represent losses.

ATTACHMENT III

Net Premiums Written and Underwriting Gains/Losses Estimated for All Insurance Lines for 1985 ($ in billions)

Selected long-tailed insurance lines[a]	Net premiums written	Premiums as a percent of all lines	Underwriting gains/(losses) after dividends	Underwriting gains/(losses) as a percent of all lines
Automobile liability	$35.7	25.1%	($7.3)	29.0%
Workers compensation	16.8	11.8	(3.7)	14.7
General liability	11.1	7.8	(4.6)	18.3
Medical malpractice	2.6	1.8	(1.4)	5.6
Subtotal	66.2	46.5	(17.0)	67.6
Selected short-tailed insurance lines[a]				
Automobile physical damage	24.9	17.5	(0.3)	1.2
Homeowners multiple peril	15.0	10.5	(1.8)	7.1
Commercial multiple peril	11.7	8.2	(3.0)	11.9
Subtotal	51.6	36.2	(5.1)	20.2
All others[b]	24.5	17.2	(3.1)	12.3
Total all lines	$142.3	100%[c]	($25.2)	100%[c]

[a]Long-tailed insurance lines are lines characterized by third-party involvement (an injured party other than the insured) and by settlements that will occur in an unknown future time period. Short-tailed lines, on the other hand, typically involve only two parties (the insurer and the insured) and settlements that will take place within a relatively short time frame (generally a year or two) following a claim.

[b]Includes such long-tailed lines as reinsurance and group accident and health, as well as such short-tailed lines as burglary and theft, and aircraft.

[c]Does not add due to rounding.

ATTACHMENT IV

Break Even Analysis for the Medical Malpractice Line in 1984
($ in millions)

Computation of Additional Earned Premiums Needed to Break Even:

Premiums earned	$1,707	
Net investment gains[a]	750	
Total Revenues		$2,457
Less:		
Net losses incurred	$1,913	
Expenses and dividends	868	
Total Outlays		2,781
Net income/(loss) before taxes		($323)[b]
Sales commissions on additional premiums ($323 / (1-.052) - $323)[c]		18
Additional earned premiums needed to break even before commission		$341
Percent additional earned premiums needed to break even ($341 / $1,707) x 100)		20.0%

[a]Does not include unrealized gains.

[b]Does not add due to rounding.

[c]Commissions paid on this line averaged 5.2 percent of premiums written.

ATTACHMENT V

Break Even Analysis for the General Liability Line in 1984
($ in millions)

Premiums earned	$6,251	
Net investment gains[a]	1,665	
Total Revenues		$7,916
Less:		
Net losses incurred	$5,456	
Expenses and dividends	4,100	
Total Outlays		9,556
Net income/(loss) before taxes		($1,640)

Computation of Additional Earned Premiums Needed to Break Even:

Sales commissions on additional premiums ($1,640 / (1-.121) - $1,640)[b]	226
Additional earned premiums needed to break even after commission	$1,866
Percent additional earned premiums needed to break even (($1,866 / $6,251) x 100)	29.8%

[a]Does not include unrealized gains.

[b]Commissions paid in this line averaged 12.1 percent of premiums written.