REFORM IN LIGHT OF THE INSURANCE CRISIS: INVESTMENT INCOME AND FEDERAL REGULATION VERSUS PROFIT ALLOWANCE AND STATE REGULATION

INTRODUCTION

Property and casualty insurance companies primarily operate to insure individuals and commercial enterprises against losses arising out of legal liability for injuries to other persons.[1] Additionally, property and casualty insurers serve as important institutional investors, providing the U.S. economy with large amounts of capital. In 1984 alone, property and casualty insurers invested $195 billion, or seventy-four percent of their assets, to stimulate economic growth.[2] Consequently, insurance companies (in conjuction with pension funds) are second only to thrift institutions as a source of capital in the U.S. economy.[3]

Policyholders' premium surpluses, unearned premium reserves and loss reserves provide insurance companies with a large amount of investment capital.[4] In return for premiums received, insurers promise to indemnify their policyholders for costs derived from the occurrence of a specified event or accident.[5] Insurance companies must be able to fulfill this contractual obligation. Therefore, the financial solvency of the insurer must be assured.[6] When investing capital derived from premiums entrusted to it by its policyholders, the primary concern of insurance companies should be the safety of the principal with the maximum yield consistent with such safety. This requires that an insurance company's capital should be secured by investing in relatively low risk and, consequently, low yield securities.[7]

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1. SECURITIES & EXCHANGE COMMISSION, 2 INSTITUTIONAL INVESTOR STUDY REPORT 783-84 (1971).
2. *See* INSURANCE INFORMATION INSTITUTE, INSURANCE FACTS: 1985-1986 PROPERTY AND CASUALTY FACT BOOK 1 (1985) (the other 26% of their assets was in office space, equipment, supplies and cash).
3. Estimated amounts for 1983 and projected amounts for 1984 invested by insurance companies and pension funds were, respectively, $85 billion and $90 billion. Similar investments by thrift institutions were $85.7 billion and $91.7 billion; investment companies, $39.6 billion and $33.3 billion; mortgage companies and real estate investment trust, $1.2 billion and $1.7 billion; commercial banks, $34.2 billion and $46.5 billion; government, $13.9 billion and $17.2 billion; foreign investors, $10.2 billion and $9.5 billion; business corporations, $0.3 billion and $0.2 billion; individuals and other sources, $2.6 billion and $0.3 billion. *See* BANKERS TRUST COMPANY, CREDIT AND CAPITAL MARKETS 1984 T-8 (1984).
4. *See* INSURANCE INFORMATION INSTITUTE, *supra* note 2, at 23.
5. *See* G. COUCH, CYCLOPEDIA OF INSURANCE LAW § 1.2 (R. Anderson 2d ed. 1984).
6. The Supreme Court has dealt with this concern and held that contracts of insurance may be said to be interdependent. German Alliance Insurance Co. v. Lewis, 233 U.S. 389, 414 (1914). They cannot be regarded singly, or isolatedly, and the effect of their relation is to create a fund of assurance and credit. The companies become the depositories of the money of the insured; thereby they possess great power and are charged with great responsibility. *Id.*
7. In 1905, the Armstrong Investigation was organized in New York to protect the insurance industry from reputed dishonesty and bad management. It revealed the inadequacies of insurance regulation with respect to investments. The Armstrong committee concluded that risk capital or

Because the paramount obligation of the insurer is to remain financially solvent so it may fulfill its contractual obligations, practically every state has laws regulating both the type of securities and the percentage of assets insurance companies may invest in them.[8] Even subject to such restrictions, insurance investments have reaped tremendous returns since 1979.[9] In recent years, however, insurers began suffering losses from policy underwriting.[10] It appears that the inflationary years of the late 1970s and early 1980s, which brought high interest rates, provided insurance companies with a windfall in investment income. This caused insurers to rely more on investment income than on underwriting gains.[11] In the 1980s, however, with much lower and stable interest rates, the growth of investment income has slowed to the point where it can no longer cover underwriting losses.

A result has been the so-called insurance crisis. The crisis is one of affordability for some risks and availability for others.[12] Insurers claim that increasing litigation and higher average settlements have forced them to sharply increase premiums and even stop assuming certain types of risks.[13] In support of this, insurers point to increasing losses from underwriting.[14] Insurance industry critics argue that overabundant investment returns lulled insurance companies into imprudent underwriting for which they are now paying the price.[15] One thing is clear: the insurance crisis has, at least chronologically, followed the leveling off of investment income. The question remaining is whether the investment income decline caused the insurance crisis, and if it did, whether the crisis could have been avoided by better regulation of investment income or better regulation and methods of setting underwriting premiums.

INVESTMENT INCOME AND THE INSURANCE CRISIS

By relying heavily on investment income, insurers helped pave the way for the insurance crisis. When inflation of the late 1970s brought on

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venture loans were not desirable investments of insurance funds and that safety of principal, rather than return on principal, should be the primary consideration. *See* Day, *Government Regulation of Insurance Company Investments,* in UNIVERSITY OF CHICAGO CONFERENCE ON INSURANCE 95, 96 (1954).

8. The investments of an insurance company are the primary responsibility of the state that chartered the company and the insurance commissioner of that state. W. VANCE, HANDBOOK ON THE LAW OF INSURANCE 43 (B. Anderson 3d ed. 1951).
9. The net investment income for property and casualty insurers for the following years: 1979, $10 billion; 1980, $11 billion; 1981, $13.2 billion; 1982, $14.9 billion; 1983, $18.1 billion; 1984, $17.6 billion; 1985 (estimated), $22 billion; 1986 (forecast), $25 billion. *See* U.S. DEPARTMENT OF COMMERCE, U.S. INDUSTRIAL OUTLOOK, 1986 § 51-6 (1985).
10. *See id.* at § 51-6.
11. *See* Eason, *Insurers' Mounting Troubles*, N.Y. Times, Feb. 14, 1984, at D1, col. 4.
12. *See* U.S. DEPARTMENT OF COMMERCE, *supra* note 9, at § 51-6.
13. *See generally The Manufactured Crisis*, 51 CONSUMER REP. 544 (1984).
14. Underwriting losses for property and casualty insurers for the following years were: 1979, $1.3 billion; 1980, $3.3 billion; 1981, $6.3 billion; 1982, $10.3 billion; 1983, $13 billion; 1984, $20.5 billion; 1985 (estimated), $20 billion; 1986 (forecast), $22 billion. *See* INSURANCE INFORMATION INSTITUTE, *supra* note 2, at 19.
15. *See* Stewart, *The "Tort Reform" Hoax*, TRIAL, July 1986, at 89, 92-93.

high interest rates, insurers realized excessive investment earnings. The years 1977-79 were so good for insurers that they spawned new insurance companies seeking their share of the new-found investment income and, thereby, increased competition.[16] Because of new competitive pressures, insurers cut premiums below cost, using portions of their investment earnings to decrease premiums.[17]

A premium war followed, and policyholders reaped the benefits of the fierce competition. Some policyholders negotiated premium reductions of up to twenty-five percent.[18] Expecting to profit from the accelerated investment income, insurers followed a policy of cash-flow underwriting[19] and aggressively underbid each other. The losses that resulted were more than compensated for by the windfall of investment income from increasing investment yields.[20]

The premium war was also aggravated by the lack of strong price leadership in the property and casualty insurance industry. With about 3,500 individual companies underwriting property and casualty risks, no single company controls more than ten percent of the market.[21] In 1981, with a market share of 3.5%, Aetna Property and Casualty Insurance Company unilaterally increased its rates and lost 0.5% of its market.[22] Without effective price leadership, insurers were suffering from their own success.

In recent years, however, inflation has slowed considerably. Consequently, interest rates have dropped, and, in response, investment income has slowed. But underwriting losses continue.[23] From 1984 to 1985 alone, underwriting losses for property and casualty insurers increased by fifteen percent.[24] Investment income is now inadequate to fill the gap caused by this underwriting loss. Underwriting losses are so severe that they have consumed investment income, as well as premium surpluses and reserves. It is this situation that caused insurers to react by increasing premiums and refusing to underwrite high risks.

REGULATION OF INVESTMENTS

The insurance industry is subject to regulation by virtue of its being a business affected with a public interest.[25] Although other industries are

16. *See generally* King & Ehrich, *Insurers are Scrambling to Break Their Losing Streak*, BUS. WEEK, Dec. 3, 1984, 144.
17. *See* J. MAGINN & D. TUTTLE, MANAGING INVESTMENT PORTFOLIOS 112 (1983).
18. *See Price Cutting Bleeds the Casualty Insurers*, BUS. WEEK, Nov. 8, 1982, at 88.
19. *See* Eason, *supra* note 11, at D1.
20. Investment income was deemed so fruitful that insurers began selling "retroactive insurance," whereby an insured could purchase coverage for a risk-event that already had occurred. Insurers calculated they could invest the premium at high enough interest rates during the usually lengthy period before the claim would be settled. The MGM Grand Hotel was the first major retroactive insurance case, which also demonstrated the fallability of the theory. MGM settled most of the claims within half the expected time, and the settlements were more than double what was projected.
21. *See* INSURANCE INFORMATION INSTITUTE, *supra* note 2, at 1.
22. *See* King & Ehrich, *supra* note 16, at 144.
23. *See* U.S. DEPARTMENT OF COMMERCE, *supra* note 9, at § 51-6.
24. *See id.* at § 51-6 (first-half operating results for property and casualty insurers in 1984 and 1985, respectively; loss of $8.8 billion, loss of $10.2 billion).
25. *See generally* G. RICHARDS, LAW OF INSURANCE § 39 (W. Freedman 5th ed. 1952); Wilson,

also regulated because of their "public interest,"[26] insurance historically has been subject to comparatively tight government control.[27] The reason for such extensive regulation has been concern for the security of the policyholders.

A central element of regulation has been the states' power to approve investments of insurance companies.[28] As early as the nineteenth century, the investing power of insurance companies has been viewed as central to the security of policyholders. In *Commonwealth v. Vrooman*,[29] the Pennsylvania Supreme Court focused on the investing operations of insurance companies when it enumerated the interests of policyholders. The court said laws regulating the insurance business should ensure the continued permanency of the custodian of the funds paid by the policyholders because it is that upon which policyholders depend for indemnification. The court also noted that regulations should assure the honest and competent administration of premium funds and prevent the funds from being divided in ways that would injure policyholders.[30]

State regulation of insurance began when state legislatures granted charters to insurance companies.[31] As separate administrative bodies were formed to specifically oversee the regulation of insurance companies, investments became the responsibility of the insurance department that chartered the company.[32] The power to invest is a power of a corporation and "like all powers of a corporation, is subject to regulation and control by the sovereign state to which the corporation owes its allegiance."[33]

The Scope of Regulation

Every state and the District of Columbia have regulations regarding insurance company investments.[34] Generally, such laws regulate insurance investments in several aspects:

Property Affected With A Public Interest, 9 S.C.L. REV. 5 (1935). *See also* German Alliance Insurance Co. v. Lewis, 233 U.S. 389 (1914); McCarter v. Fireman's Insurance Co., 74 N.J. Eq. 372, 73 A. 80 (1909).

26. *See* Wilson, *supra* note 25, at 11 (generally identifies commodities and commercial transportation industries as being affected with a public interest).
27. For discussion of the history of insurance regulation, *see* R. HENSLEY, COMPETITION, REGULATION, AND THE PUBLIC INTEREST IN NONLIFE INSURANCE 75-78 (1962); AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH, FEDERAL-STATE REGULATION OF THE PRICING AND MARKETING OF INSURANCE 13-22 (P. MacAvoy ed. 1977) [hereinafter cited as Federal-State Regulation]; G. RICHARDS, *supra* note 25, at § 40.
28. *See* G. RICHARDS, *supra* note 25, at § 41.
29. 164 Pa. 306, 30 A. 217 (1894).
30. 30 A. at 219.
31. *See* UNITED STATES GENERAL ACCOUNTING OFFICE, ISSUES AND NEEDED IMPROVEMENTS IN STATE REGULATION OF THE INSURANCE BUSINESS: REPORT TO THE CONGRESS, EXECUTIVE SUMMARY 3 (1979).
32. *See* W. Vance, *supra* note 8, at 43.
33. Prudential Insurance Co. of America v. Richman, 292 Ill. App. 261, 11 N.E.2d 126, 129 (1937) (holding that an insurance company licensed under the Insurance Acts of Illinois has the implied power to invest its money in mortgages and take security to protect the collection of the money invested).
34. *See* J. MINTEL, INSURANCE RATE LITIGATION 3 (1983).

1) State regulations set out what type of investments are allowed. Such authorized investments usually include U.S. bonds or securities, various state, local and municipal bonds and notes, bonds or other securities of corporations, and, subject to various limitations, real estate.[35]

2) State insurance laws usually set qualitative requirements for certain investments, such as corporate securities. Before bonds or stocks of a corporation may be purchased by an insurance company, it must be established that the corporation has had some minimum level of earnings, has been solvent for five to ten years, or has not defaulted on interest or loan payments for the past five years.[36]

3) States also require a certain amount of portfolio diversification by insurance companies. Limitations are placed upon the percentage of the insurer's admitted assets that may be invested in any one investment.[37]

4) With respect to real estate, most states limit the amount that may be owned by an insurance company. Further, mandatory disposition of property held for longer than five to ten years is required.[38] As for loans or mortgages, state regulations limit the amount of loan or security of real property to some fraction of the market value of the collateral.[39]

5) Some states have instituted "leeway" or "basket" provisions, which permit insurers to invest a limited percentage of assets in otherwise unauthorized investments to establish a safety net for several contingencies.[40] These provisions allow for difference of interpretation in regulations between the legislature, the state commissioner and insurance companies. They also deal with sudden changes that could cause authorized investments to become unauthorized. Third, the provisions permit insurers to readily take advantage of new and innovative investment opportunities not yet specifically authorized.[41]

GOALS OF INSURANCE REGULATION

Reviewing the general types of regulations imposed on the investing activities of insurers, several objectives of regulation become apparent. Primarily, investment regulations seek to protect policyholders with regulations that prevent insurance company management from making speculative investments.[42] This intent is evidenced by the specificity of authorized investments and the requirements of minimum quality and sufficient diversification. Second, to reduce vulnerability to sudden shifts in eco-

35. *See, e.g.*, IND. INS. LAWS § 27-1-13-3(b)-(d) (1986). *See also* Kimball & Denenberg, *The Regulation of Investments*, in INSURANCE, GOVERNMENT, AND SOCIAL POLICY: STUDIES IN INSURANCE REGULATION 126, 130-35 (S. Kimball & H. Denenberg eds. 1969).

36. *See, e.g.*, IND. INS. LAWS § 27-1-13-3(b)(7) (1986). *See also* Kimball & Denenberg, *supra* note 35, at 133.

37. *See, e.g.*, IND. INS. LAWS § 27-1-13-3(b)(11) (1986) (limiting this type of investment to 10%). *See also* Kimball & Denenberg, *supra* note 35, at 132.

38. *See, e.g.*, IND. INS. LAWS § 27-1-13-3(d) (1986) (does not apply to office property).

39. *See, e.g.*, IND. INS. LAWS § 27-1-13-3(b)(9) (1986) (limiting loan to 75% of market value of collateral).

40. *See* Kimball & Denenberg, *supra* note 35, at 135.

41. *See id.*

42. *See id.* at 127.

nomic circumstances, insurance regulations seek to stabilize the financial position of insurers.[43] Thus, a limit of ten percent of insurance company assets as the maximum single investment amount is common.[44]

Another objective of investment regulations is the state's interest in preventing overconcentration of the economic power of insurance companies.[45] Legislatures have prevented insurance companies from controlling other corporations by making it illegal for them to buy large blocks of corporate stock.[46]

Changes in State Regulatory Efforts

State regulations regarding insurance company investments have changed over the years. The general trend has been one of loosening control over investment policy.[47] Such liberalization is based largely upon insurance commissioners' realization that most insurance companies follow sound investment policy and that previous regulations did more to hinder than promote investment goals.[48] Further, new investment instruments have emerged as the U.S. economy has evolved. Legislative changes may come too slowly, causing insurers to miss prime investment opportunities.

In their zeal to protect the social obligation of insurance companies to policyholders, legislatures and insurance regulation agencies often overlook the fact that the insurance companies try to secure and maximize their capital bases. It is clear that the regulation of insurance investments had little, if any, role in the insurance crisis. In fact, regardless of already strict regulations, insurers still have achieved high yields on their investments.[49] What has not been examined, however, is the proper use of investment returns in underwriting and the setting of rates.

INVESTMENT INCOME AND RATEMAKING

The insurance business is affected with the public interest to such an extent that rates may be regulated by law.[50] Indeed, all fifty states and the District of Columbia have adopted various laws and established executive departments for regulating insurance.[51] The aim of such regulatory machinery is to protect insureds by securing insurers' solvency and ability to indemnify policyholders.[52]

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43. *See id.*
44. *See, e.g.*, IND. INS. LAWS § 27-1-13-3(b)(11) (1986). *See also* Kimball & Denenberg, *supra* note 35, at 132.
45. *See* Kimball & Denenberg, *supra* note 35, at 128.
46. Insurance companies can invest only up to ten percent of their stated assets in a corporation. *See id.* at 128. Similarly, legislatures have independent social objectives behind insurance investment regulations. For example, an exception to the limit applies to real estate investments to encourage investment in such projects as public low-income housing. *See id.*
47. *See id.* at 136.
48. *See id.*
49. *See* U.S. DEPARTMENT OF COMMERCE, *supra* note 9, at § 51-6.
50. German Alliance Insurance Co. v. Lewis, 233 U.S. 389 (1914).
51. *See supra* note 34 and accompanying text.
52. *See, e.g.*, IND. INS. LAWS § 27-1-13-3(a)(4) (1986).

Policyholders have the dual interest that the premiums be high enough to adequately pay all losses, but not so high that insurance is not affordable.[53] Rate regulation, by preventing inadequate rates, is an important aid to helping guarantee insurer solvency. By preventing excessive rates, it also preserves the affordability of risk protection.[54]

Factors in Insurance Ratemaking

In determining rates, three cost factors are taken into account—the expected loss, expenses and profit allowance.[55] The expected loss is the insurer's estimate of the dollar loss that will be realized by the average insured within a particular risk category.[56] The expense component of the premium rate is the amount needed to cover the overhead expenses of the insurer. Such expenses include various production costs, taxes, licenses, fees and other general administrative expenses.[57] The allowance-for-profit factor is designed to provide the insurer with a reasonable profit, as well as a buffer between expected and actual losses and expenses.[58]

Price setting, however, is subject to government control in all states.[59] There are generally two types of state regulation of insurance rates.[60] The first, which was the type originally adopted by most states, is the prior-approval method. Insurers must obtain approval from state insurance commissioners under this method before rate changes become effective.[61] Most states still use the prior-approval method. Other states have developed an open-rating system, whereby rates are set by insurers themselves, without prior approval of the commissioner.[62] The commissioner, however, has the power to later rescind excessive rates, subject to an administrative hearing.[63]

The rate regulatory laws of the states provide only general standards, according to which the insurance commissioner must evaluate the rates.

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53. *See* R. HENSLEY, *supra* note27, at 10-11.
54. *See* Mayerson, *Ensuring the Solvency of Property and Liability Insurance Companies*, in INSURANCE, GOVERNMENT, AND SOCIAL POLICY, 188 (S. Kimball & H. Denenberg eds. 1969); FEDERAL-STATE REGULATION, *supra* note 27, at 33; J. MINTEL, *supra* note 34, at 2.
55. *See* AMERICAN INSTITUTE FOR PROPERTY AND LIABILITY UNDERWRITERS, 1 PRINCIPLES OF RISK MANAGEMENT AND INSURANCE 127-28 (1978).
56. The expected loss is determined from statistics compiled for previous years, which are subject to further considerations of accuracy, credibility, length of experience period, and trends and loss development factors. For a discussion of the interplay of those factors and judicial response to them, *see* J. MINTEL, *supra* note 34, at 162-70.

    A common misconception of ratemaking is simplification to a comparison between losses paid in one year to premiums written that same year. *See* J. MINTEL, *supra* note 34, at 161.
57. *See id.* at 172.
58. *See* AMERICAN INSTITUTE FOR PROPERTY AND LIABILITY UNDERWRITERS, *supra* note 55, at 128.
59. McCarran-Ferguson Act of 1945, 15 U.S.C. §§ 1011-15 (1982). The Act gave the states until January 1, 1948, to institute regulation dealing with the insurance industry. After January 1, 1948, federal antitrust laws became applicable to the insurance industry in areas that were not yet regulated by state law. Every state has pursued statutes that, effectively, remove the matter of insurance regulation from federal control under the McCarran-Ferguson Act.
60. A third type of ratemaking followed by some states left it up to the state insurance commissioner to set insurance rates. *See* FEDERAL-STATE REGULATION, *supra* note 27, at 17.
61. *See Sudden Riches For Casualty Insurers*, BUS. WEEK, May 1, 1978, at 66, 68.
62. *See id.* at 68 (also known as the "file and use" system).
63. *See id.*

Rate laws prohibit insurance rates that are excessive, inadequate or discriminatory.[64] It is under the "excessive" standard that recent pressure to include investment income in determining rates has been brought.[65]

Profit Allowance in Ratemaking

Because of the recent acceleration of investment income returns, consumer groups have asked legislatures to have income from all sources considered in establishing rate levels.[66] Specifically, the trend has been to require investment income to be used in determining the appropriate profit allowance. Traditionally, profit allowance provisions were established to protect the insurers. Property and casualty insurance is a unique business; the ultimate cost of their product (the insurance policy) cannot be determined until after the policy has ended. Thus, because insurers provide a socially useful service, and because a large element of chance is inherent in the pricing of insurance coverage, a guaranteed profit is calculated into the premium level.[67]

In 1921, the National Association of Insurance Commissioners introduced the Standard Profit Formula.[68] This formula allowed a designated five percent profit return from every policy underwritten.[69] Such a guaranteed profit was considered fair and reasonable, because it helped protect the insurer in case the premium was too low.[70] Furthermore, the NAIC specifically provided that investment income should not be considered in the setting of rates.[71]

THE FUTURE OF RATEMAKING

Investment income has become a larger portion of insurers' net worth in recent years. It would appear that the need for a guaranteed margin of profit from underwriting has declined. Indeed, the National Association of Insurance Commissioners assembled a task force on profitability and investment in 1982 to study the possibility of reflecting investment income in the ratemaking formula.[72] In an advisory report to the NAIC task force, advisory committee members J. Robert Hunter and John W. Wilson supported the use of investment income in setting rates, stating that the "time had clearly come for the insurance industry regulators to explicitly

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64. *See, e.g.*, IND. INS. LAWS § 27-1-22-1 (1986). For court decisions upholding such standards, *see* J. MINTEL, *supra* note 34, at 147.
65. "In today's economy, traditional underwriting profit allowances, coupled with investment income, would produce returns that greatly exceed the industry's cost of capital." J. WILSON & J. HUNTER, INVESTMENT INCOME AND PROFITABILITY IN PROPERTY/CASUALTY INSURANCE RATEMAKING (1983).
66. *See* Jewell, *Insurer's Investment Income and Profitability*, 24 FOR. DEF., July 1982, at 24, 25.
67. *See id.* at 25.
68. *See id.* (at that time, the NAIC was the National Convention of Insurance Commissioners).
69. *See* Jewell, *supra* note 66, at 25.
70. *See* Strazewski, *Include Investments in Ratemaking: NAIC Panel*, Bus. Ins., Jan.30, 1984, at 1, col. 2.
71. *See* Jewell, *supra* note 66, at 25.
72. *See id.*

include investment income in the ratemaking and approval process."[73] They also belived that "both the underwriting practices of insurance companies and the recent dramatic increases in the level of investment income, to the point where it greatly exceeds the level of underwriting income, clearly demonstrate that the '1921 Standard Profit Formula' is no longer relevant."[74]

The NAIC task force agreed with Hunter and Wilson. The draft from the task force concluded that regulator-approved rates that guarantee an underwriting profit in addition to investment income lead only to excessive insurance company profits.[75] Furthermore, such profits go beyond the legitimate interest in preserving the insurer's financial solvency.[76]

State courts have held that, subject to the particular wording and intent of their statutes, state insurance commissioners have the power to consider investment income in the ratemaking process.[77] The insurance industry has rejected such a derivation from the traditional rate regulation. Insurance lobbyists argue that no reason exists to alter the 1921 Standard Profit Formula. The Insurance Services Office, the industry's rate and policy advisory organization, claims there is no evidence of excessive profits when underwriting losses are considered.[78] Insurance officials also argue that competition, and not theoretical models estimating investment income, should set insurance rates.[79]

The Debate Over Investment Income

A major disagreement about requiring ratemaking to reflect returns from investment income centers on how it should be accomplished. Insurers claim that there is no practical way to include investment returns in setting premiums.[80] The NAIC task force was even cautioned by

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73. J. WILSON & J. HUNTER, *supra* note 65, at 169 (minority report).
74. R. CADDY, LEGISLATIVE TRENDS IN INSURANCE REGULATION 170 (1986).
75. *See* Strazewski, *supra* note 70, at 1.
76. *See id.*
77. Because of the construction of their ratemaking statutes, Virginia and Oklahoma allow the insurance commissioner to consider investment income. *See* Virginia State AFL-CIO v. Commonwealth of Virginia, 209 Va. 776, 167 S.E.2d 322 (1969); Oklahoma State AFL-CIO v. State Board for Property and Casualty Insurance Rates, 463 P.2d 693 (Okla. 1977).
78. *See* Strazewski, *Industry Officials Criticize NAIC Report on Ratemaking*, Bus. Ins., Mar. 12, 1984, at 2, col. 3 (statement of Mavis A. Walters, Senior Vice President of the Insurance Services Office).
79. The insurance marketplace proves to be a better measure of rate adequacy for individual insurers than any financial ratemaking model applied to the industry as a whole. *See id.* at 72. Insurers also point out that the natural market competition already forces investment income to be considered in setting rates. *See id.* at 2.
80. *See* McHugh, *The Real Issue: State Versus Federal Or Regulation Versus Competition?*, in INSURANCE, GOVERNMENT, AND SOCIAL POLICY: STUDIES IN INSURANCE REGULATION 193, 207 (S. Kimball & H. Denenberg eds. 1969). Indeed, it has been difficult for critics of the insurance industry to counter the industry's argument, because most insurance companies keep financial data under wraps. Insurance accounting, ratemaking techniques, measures of profitability, reserving practices and underwriting evaluations always have confused the public. The insurance industry does little to dispel this mistrust by refusing to follow Generally Accepted Accounting Principles. *See* Strazewski, *supra* note 78, at 72. The GAAP are designed to allow companies in all types of industries to report on a uniform basis. Insurance industry officials refuse to do so, claiming that it would be an unappropriate reporting basis for ratemaking purposes. *See id.*

insurance commissioners themselves that both they and the property-casualty insurers lacked the experience necessary to determine the most reasonable regulatory approach.[81]

The NAIC report produced two possible methods to estimate insurers' investment income for purposes of setting rates. The first is the risk-free rate of return.[82] The rate of return is indexed to the yield of an acceptable risk-free investment instrument, such as U.S. Treasury Bills. Such a valuation, however, is susceptible to several drawbacks that could result in a significant underestimation of the actual returns. Generally, only a small percentage of insurance company investments are committed to such risk-free securities.[83] Indexing also insulates the estimated investment return from rapid changes in interest rates, which greatly affect the actual yields on investments.

Consequently, the NAIC has proposed another alternative method, an "actual rate of return" model.[84] This model takes into consideration the actual anticipated net investment income, likely capital gains and the insurer's ratio of assets to net worth. The task force felt that this would more accurately reflect the income expected to be received, because it takes into account the various investments used and the company's expected returns.

The insurance industry believes that other methods of estimating investment income would be more accurate. Insurers advocate estimates based on a previous-year average of returns or a likely range of return.[85] The basic difference between the various models is that the task force's models use actual expected income, rather than the insurer supported past history models, which would tend to result in underestimations of investment income. Judicially, different courts express different attitudes on whether investment income should be used and what method should be followed in calculating the profit allowance with investment income.[86]

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81. *See* R. CADDY, *supra* note 74, at 169.
82. *See* Strazewski, *supra* note 70, at 71.
83. *See* INSURANCE INFORMATION INSTITUTE, *supra* note 2, at 23 (in 1984, only 19% of insurance company (investments were in government bonds).
84. *See* Strazewski, *supra* note 70, at 1.
85. *See id.* at 71.
86. In Attorney General v. Commissioner of Insurance, 370 Mass. 791, 353 N.E. 745 (1976), the Massachusetts insurance commissioner argued that the Standard Profit Formula was the "shoddiest component of ratemaking" and substituted a capital assets pricing model. 353 N.E.2d at 760. Under that model, the commissioner determines the target rate of return from the premium and then calculates the estimated after-tax return on capital using a minimum reasonable investment yield. The profit allowance is then adjusted so that the total return calculated in the after-tax return equals the target rate of return. The Massachusetts Supreme Court upheld the capital assets pricing model and noted that, although initial imprecision was acceptable, future estimates would be subject to higher standards of accuracy. *Id.* at 813-15.

Three years later, the North Carolina Supreme Court rejected the North Carolina Insurance Commissioner's use of the capital assets pricing model. State ex rel. Commissioner of Insurance v. North Carolina Rate Bureau, 300 N.E.2d 381, 269 S.E.2d 547 (1980). The court ruled the use of the model erroneous as a matter of law, and arbitrary and capricious. 269 S.E.2d at 589-90. Consideration of investment income is not allowed under North Carolina insurance law. Further, calculations made according to risk-free investments are inapplicable because such investments are outside the scope of authorized investments under North Carolina insurance

What is painfully evident is the confusion surrounding the investment income of insurance companies. Not only is there disagreement between insurers and their policyholders, but also between the NAIC task force report and some insurance commissioners. Insurers resist having their profit allowance reduced by investment income. They claim such income is already reflected in their premium pricing, because of competitive pressures. Consumer advocates believe that if investment returns were expressly set against the traditional guaranteed profit margin, premium levels would decrease. When some state insurance commissioners have tried to implement such ratemaking plans, they have been thwarted by their states' statutes and legislative histories.

THE NEED FOR FEDERAL REGULATION

The purpose of regulation is to protect the public interest and keep the insurance industry responsive to current public needs and current realities.[87] The conflict caused by investment income rate setting demonstrates that a single uniform treatment of the problem must be promulgated. In order to effectively and efficiently do this, the "permanence" of state regulation must succumb to the "relevance" of federal regulation.

Congress inevitably will consider proposed solutions to the insurance crisis. In all likelihood, these proposals will focus on regulation, some calling for more, others calling for less. Such potential legislation should be accompanied by Congress' complete reassessment of present insurance regulation focused on four questions:

1. How effective has state regulation been? In light of the recent problems of affordability and availability, it appears the states have failed to effectively regulate the price of insurance.

2. To what extent is the McCarran-Ferguson antitrust exemption needed today? The McCarran-Ferguson Act was passed to allow concerted price-setting through state regulated bureaus. Insurers themselves recently have demonstrated a more independent and competitive approach, alleviating the need for special anticompetitive exemptions.

3. Is there a need for a new role by the federal government in insurance regulation? The various treatments accorded by the states to the setting of rates and investment income demonstrates the unreasonable differences that can result without more uniform laws.

4. If there is a need for federal regulation, how could it be implemented? Using the present framework of the state insurance departments, Congress could devise a federal board of insurance commissioners to

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law.

The North Carolina Supreme Court specifically refused to follow the Massachusetts decision in Attorney General v. Commissioner of Insurance and distinguished the Massachusetts case on several grounds.

87. *See* Stewart, *Ritual and Reality in Insurance Regulation*, in Insurance, Government, and Social Policy: Studies in Insurance Regulation 22, 32 (S. Kimball & H. Denenberg eds. 1969). Regulation has been defined as "the process of bringing current values of society to bear on current practices of an essential industry; hence, regulation must seek relevance more than permanence." *See id.* at 32 (statement of Richard E. Stewart, former New York Insurance Commissioner).

coordinate the activities of the individual state agencies. Further, by providing the Federal Trade Commission with authority over insurance companies, a continued exchange of data between insurers (essential to determine anticipated losses) can be maintained while any efforts of price fixing can be prevented.

CONCLUSION

The insurance crisis presents problems of affordability and availabilty of insurance protection. Consumer advocates point to record levels of investment income and blame the crisis on insurance companies. Insurance companies point to record levels of underwriting losses and blame the tort system and the legal profession.

The tension is unlikely to dissipate. Policyholders are always ready to accept premium reductions for any reason and rarely accept increases, even for good reasons. Some insureds used the competition wars of the early 1980s to negotiate further decreases in their premiums. Now that competition has eased and premiums have increased, policyholders believe advantage is being taken of them.

The fundamental problem that emerges is how the business of insurance is to be treated. The insurance industry's position is that it is divided into two distinct branches, the underwriting business and the investment business.[88] Therefore, only income related to their underwriting practices should be considered in ratemaking. Conversely, consumer groups regard the insurance business as a single, indivisible whole.[89] Any type of income is attributed to the business as a whole, and no underwriting profit is necessary if income from investment is adequate to compensate for the underwriting risk.

The matter is complicated by the fact that each state takes its own view.[90] The lack of uniformity among the state insurance codes and regulations has achieved nothing more than to increase confusion in an already mysterious industry. Regardless of the political infeasibility of federal regulation in the face of the current trend away from government regulation, Congress should work toward a uniform regulatory approach that will serve the interest of the public, not the insurance industry.

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88. This argument has been presented successfully in court. *See* Commissioner of Insurance v. North Carolina Rate Bureau, 300 N.C. 381, 446, 269 S.E.2d. 547, 587 (1980).
89. 269 S.E.2d at 587.
90. North Carolina, for example, according to its own legislative history and its own insurance regulations, clearly recognizes the dichotomy between the underwriting and investment activities. *See id.*

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