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The Life Insurance Industry in the United States

An Analysis of Economic and Regulatory Issues

Kenneth M. Wright

In the complex, highly developed U.S. life insurance industry, regulation emphasizes prudence and solvency and does not inhibit competition and innovation. But because there are no satisfactory measures of efficiency and profitability, it is difficult to assess industry performance.

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This paper — a product of the Financial Policy and Systems Division, Country Economics Department — is part of a larger effort in the department to study policies that promote financial sector development. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Wilai Pitayatonakarn, room N9-003, extension 37664 (47 pages). February 1992.

The U.S. life insurance industry comprises more than 1,200 active companies with an impressive record of innovation. Annual premiums for life insurance and annuity products amount to about 5 percent of GNP and total assets to 26 percent of GNP.

Life insurance companies are major participants in U.S. capital markets. They invest in all types of bonds, mortgage loans and mortgage-backed securities, and corporate equities. They hold about one-third of all corporate bonds and about 15 percent of mortgage-backed securities. Conservative policies and regulations keep their holdings in corporate equities down to only 3 percent of all corporate equities — and to about 9 percent of their total assets (compared with 38 percent for corporate bonds and 13 percent for government bonds).

In describing the characteristics of products that life insurance companies offer, Wright highlights how fiscal incentives promote long-term financial savings. He notes that although federal tax laws are complex, their guiding principle is to favor insurance protection and saving for retirement, while discouraging the abuse of tax privileges for short-term investment.

Insurance regulation is fragmented among state authorities, but coordinated through the National Association of Insurance Commissioners (NAIC). New York state rules are influential because companies based elsewhere that want to operate in New York must comply with New York rules.

Regulation emphasizes prudence and solvency. There are no minimum requirements for investing in government bonds or "high-priority" sectors, but tight maximum limits are often imposed on different assets, especially holdings of corporate equities, and on agents' commissions. In recent years, regulations have emphasized the "prudent man" rule and have relied on solvency monitoring — including the use of valuation reserves for investment assets — to ensure insurance companies' safety.

Wright underscores the lack of satisfactory measures of efficiency and profitability, which is explained by the long-term nature of the contracts, differences in the use of mortality tables and discount rates, and differences in the valuation of assets and the treatment of unrealized capital gains. This hampers an objective assessment of the industry's performance and raises problems for insurance taxation.

Wright also reviews some public policy issues that affect life insurance companies, including nontaxation of the companies' investment income, life insurer solvency, state versus federal regulation, guarantee funds and moral hazard issues, investment regulation and safety, accounting standards for asset valuation, and links between banks and insurance companies.

THE LIFE INSURANCE INDUSTRY

IN THE UNITED STATES

An Analysis of Economic and Regulatory Issues

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FOREWORD

The financial systems of most developing countries are dominated by their banking sectors. With few notable exceptions (Singapore, Malaysia, Chile and Korea), long-term contractual savings institutions, such as pension funds and life insurance companies, play a small part in most countries. There are three main reasons for this underdevelopment of contractual savings: the low level of income; the existence of unfunded social security systems; and the imposition of restrictive regulations on insurance companies (World Bank, 1989 and Vittas and Skully, 1991).

Insurance operations have been subject to tight restrictions in most developing countries. The sector has often been monopolized by state-owned companies, competition and innovation have been stifled by controls on premiums and products, and accumulated funds have been invested in low-yielding government securities. With highly negative returns on their investments, insurance companies have effectively operated as (inflation) tax collectors. In recent years, many developing countries have started to reform their pension and insurance systems in an attempt to mobilize long-term financial resources, promote capital markets and encourage private sector development. Reform initiatives are particularly strong in Latin American and Eastern European countries where social security systems experience serious financial pressures.

As insurance regulations are reformed, one question facing policy makers in developing countries is what would be the structure of a competitive industry and what kind of regulations would be required to ensure the safety and soundness of insurance assets without inhibiting competition and innovation. Unlike banking where there is wide international consensus on the importance and types of prudential regulations, in the insurance industry there are still considerable variations in regulatory philosophy, even among developed countries.

The present paper, commissioned from Kenneth M. Wright, a former director of the American Council of Life Insurance, provides an overview of the structure, performance and regulation of the US life insurance industry. Although the US life industry is highly complex, it is hoped that its impressive record of innovation and the way it deals with issues of market structure, solvency regulation and insurance taxation would have useful lessons for developing countries.

The paper is part of a series of reports on contractual savings institutions that address economic and regulatory policy issues and aim to stimulate policy reform in developing countries.

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I. INTRODUCTION

The economic and social functions of life insurance companies in the United States are aimed at providing financial security to individuals and families in two basic ways. First, life insurance offers protection against the financial risk of premature death of a family member and the consequent loss of income to the surviving family. Second, annuities and pension plans protect against the risk of outliving other forms of income, particularly after retirement from active employment. In serving these needs, life insurance companies are a major source of long-term funds to the domestic capital market through the investment of their reserves in a wide range of financial outlets.

Total assets of U.S. life insurance companies were $1,408 billion at the end of 1990, equal to 26 percent of GNP. Of these, roughly one third arose from policy reserves behind life insurance and two thirds were reserves against annuities and pension plans. Such assets rose by $108 billion in the year 1990, with the bulk of these net new funds made available to the financial markets through investment in long-term corporate debt obligations, mortgages on commercial real estate, U.S. Treasury and federal agency securities, and corporate equity issues.

Life insurance was owned by 81 percent of American households in 1990 with an average amount of coverage of $121,400 or roughly three times the size of average family income. The face amount of life insurance in force was $9.392 billion or 174% of GNP--an increase of 8.0 percent for the year.

Death benefits on life insurance policies were $25 billion in 1990, while another $18 billion was paid to policyholders in surrender values and $12 billion in policy dividends. Payments on annuities with life companies were just under $33 billion.

Premiums paid on life insurance are currently 2 percent of disposable personal income (DPI), down from a 3 percent level twenty years ago. An upsurge in annuity purchases has more than offset this declining trend, however, with annuity considerations (individual and group) rising from 0.5 percent of DPI in 1969 to 3.0 percent in 1989. Thus, total life premiums and annuity considerations have risen to 5 percent of DPI, compared with 3.5 percent 20 years ago.

The life insurance industry in the United States has long played a major role in generating savings available to the money and capital markets. Federal Reserve data show a total of $629 billion in credit provided by all types of institutions and investors in the U.S. capital market in 1989. Life insurance companies supplied $98 billion or 16 percent of the total in that year, second only to commercial banks which supplied 27 percent of the total.

The broad dimensions of the U.S. life insurance and pension field in 1989 are shown in summary form in Table 1.

At the latest count, there were 2,343 life insurance companies in the United States, of which about 1,200 companies are currently active; the others have been legally chartered but do not carry on current operations. Just under half of total industry assets are held by the 118 mutual companies while stock companies, though much larger in number, represent the remaining half of industry assets. The three largest companies are organized as mutuals; together, they account for 23 percent of total industry assets. The ten largest life insurance companies, both stock and mutual, hold 43 percent of total industry

assets. Insurance holding companies often are owners of several other stock companies, forming a "fleet" operation which combines certain central functions such as investment management into a single office.

An international aspect of life insurance operations does exist, although 't is limited in magnitude. A few U.S. life companies sell insurance in Canada, Latin America, Europe or Japan in limited quantities. A number of Canadian life companies also market their products in the United States, largely in the states close to the northern border with Canada. In addition, European financial interests based in Germany, France and the Netherlands own or control U.S.-based life insurance companies. While no firm data are available on cross- border sales by "alien" life insurance companies based outside the United States, the actual dollar volume is believed to be quite small within the U.S. total. In general, asset data cited in this study refer to life insurance companies domiciled in the United States.

Table 1

Summary Data, 1989

	Dollar Amount (in billions)	Percent of GNP
Life Insurance reserves	340	6.5
Insured pension reserves	738	14.2
Other private pension funds	1,050	20.2
State and local government employee retirement funds	727	14.0
Total non-federal	2,855	54.9
Life insurance in force	8,694	167.2
Life insurance purchases		Percent of DPI
Face amount	1,442	38.7
Life insurance premiums	73	2.0
Annuity considerations	115	3.0

The plan of this paper is to first describe the characteristics of life insurance and annuity products offered by U.S. companies, followed by a discussion of the fiscal incentives and tax treatment afforded

to these products. The investment operations of life companies will then be examined in detail, including their role in various segments of the U.S. capital market. The regulatory system which governs insurance company operations and provides consumer protection will then be described at some length, followed by a brief section on the profitability and investment returns of the life insurance industry. A final section will outline the leading policy issues that are current in the regulation, taxation and operation of life insurance companies in the United States.

II. LIFE INSURANCE AND ANNUITY PRODUCTS

Three basic forms of life insurance products may be distinguished: (1) whole-life, (2) term life, and (3) annuities. Within each category, there are numerous varieties and refinements which can provide almost any form of protection to meet the particular needs of the insurance client, but the emphasis here will be confined to the standard forms of insurance.

a. Whole-life Insurance

Sometimes known as permanent insurance or cash-value life insurance, traditional whole life insurance is based on a level-premium method of payment, whereby the policyholder pays an unchanging periodic amount for the entire life of the contract, normally until the death of the insured. In the early years of the policy, premiums are higher than needed to meet the average of death claims at younger ages; thus, a reserve is accumulated to meet the higher number of death claims at later ages when the premium payment remains level. Because there is a sizeable reserve build-up behind whole-life contracts, such policies have a cash surrender value and they typically carry a policy loan privilege.

Mutual companies selling whole life policies allow the policyholder to participate in any excess earnings on reserves, through policy dividends paid out to the insured or used to buy additional coverage. In this way, the net cost of insurance may be less than the gross premiums required under the contract. Stock companies have also offered participating policies, but non-participating policies are more standard, allowing any excess earnings above the assumed rate to remain with the company as shareholder profits.

In the early 1980s, new forms of whole life policies were developed, primarily in response to the surge in inflation rates and market interest rates to double-digit levels during the 1978-1982 period in the United States. With fixed dollar amounts on the face value of insurance policies, the real value of future death benefits was jeopardized by persistent inflation. Reacting to this threat to insurance purchases, life companies developed three new forms of "interest-sensitive" policies--universal life, variable life, and flexible premium variable life. All three had the common element of reflecting investment performance in the policies, by changing the size of the death benefit or the annual premium or both over the duration of the policy.

Under universal life, the policyholder is able to vary his annual premiums as to the amount and timing of payments. Net premiums (after loading and mortality risk charges) are invested in a floating rate fund, and the earned interest credited to the policy will vary with investment results. Death benefits cannot fall below the face value of the policy, but they can expire if the level of premium payments or the investment experience is not sufficient to carry the policy to maturity. Thus, the buyer assumes some of the investment risk, but he also can share directly in the rewards of good performance. In 1989, $275 billion of universal life was purchased, which was 16 percent of the sales of ordinary life (whole-life and term life) in that year.

Somewhat less successful was the new product called variable life, which sold less than $7 billion in 1989. Variable life carries a fixed annual premium but allows the policyholder to designate investment of his funds into bonds, equities, or a money market account and to vary his choice during the life of the policy as he sees fit. There is a guaranteed minimum death benefit, but the size of the benefit will rise or fall over time, depending on investment performance.

A combined version of the two previous policy types is flexible premium variable life, wherein premium payments may vary and a choice of investment media can be made. Death benefits will depend on investment returns on the asse s standing behind the policy. Purchases of this product were $36 billion in 1989.

Taken together, these three forms of interest-sensitive life insurance captured a 32 percent share of ordinary life sales by 1987, at the expense of traditional cash-value insurance and also cutting into the market for term insurance. However, with the reduced level of inflation and market interest rates in the United States more recently, the market share of interest-sensitive policies has declined to 24 percent.

b. <u>Term Insurance</u>

This popular form of ordinary insurance differs in major respects from whole life, primarily because it is offered for a specified number of years, usually one, two or five years. During the specified time, the premium is unchanged, based on the attained age of the insured. At younger ages, the premium is substantially lower than for cash-value life, but the premium increases sharply in later years as the likelihood of death increases on average. Term insurance is underwritten largely on a "pay-as-you-go" basis whereby current claims can be met from the inflow of current premiums paid by those covered under this system. Thus, little reserve is accumulated for investment in the financial markets to fund future death claims.

Because term insurance is the least expensive form of coverage, it appeals largely to younger adults and those with lower incomes. It generates minimal amounts of savings and provides no policy loan privileges or cash surrender values. Those who purchase term insurance are often urged to undertake a companion savings program in other forms, but these do not represent contractual savings on a continuing basis. When the policyholder reaches later years of life, the cost of term insurance can be prohibitively expensive, leading to dropping of the policy (lapsation) and a consequent absence of coverage. In the event of a major health problem, a policyholder may find that his term insurance cannot be renewed, since a physical examination is typically required whenever a new policy is purchased. However, some term policies are written to permit automatic renewal without a health review, but at a higher premium.

In the mid-1980s, purchases of term insurance rose to a peak level of 60 percent of ordinary life sold to individuals, but then declined in later years to 41 percent of total purchases by 1989, apparently because of the attraction of the new interest-sensitive policies which provided some aspects of inflation hedging and shared much of the investment results with the policy owner.

In addition to individual purchases, term insurance is marketed in large volume through group insurance, whereby a master policy is issued to an employer to cover all employees as a fringe benefit in addition to wages and salaries. A typical method is for the employer to provide group term insurance equal to 1, 1-1/2, or 2 times the annual salary level of each employee. As a rule, physical examinations are not required of those under the group contract, since it is assumed that employees currently at work are in good health. Most plans cover all employees in the working group, thus avoiding adverse selection by those in poor health, or by higher-paid employees who would receive larger amounts of coverage, or by older employees who stand to gain more from such coverage than the younger workers. Since administrative expenses are low, this form of insurance is relatively inexpensive and has grown rapidly as an employee benefit. If the employee leaves the firm, his insurance coverage is normally terminated,

but is sometimes continued if the employee has retired. At the end of 1989, group life insurance (largely term) represented 40 percent of the face amount of life insurance in force in the United States.

c. Other Life Insurance Forms

In addition to the basic policy types described above, two other insurance forms exist, though in minor amounts. One type is called industrial life, issued in amounts usually under $1,000 with premiums collected door-to-door on a weekly or monthly basis Primarily sold to low-income groups, such insurance is often meant to cover burial expenses. The outstanding number of such policies has declined to about one third the level of 30 years ago.

The other minor form of insurance is called credit insurance, designed to repay a mortgage loan or installment loan in case the borrower dies. Such insurance is often required as a condition of a loan to an individual, or is offered as a related option. Credit insurance is term insurance, usually decreasing in amount in keeping with scheduled repayments of a mortgage or an auto loan. The lending institution or retailer normally handles the sale of credit insurance, which is actually underwritten by life insurance companies. About $260 billion of such insurance is presently in force, and the average size of such policies is $3,600.

d. Annuities--Individual and Group

Annuities are designed to provide continuing income to protect against the possibility of outliving other forms of income, usually beginning with retirement from active employment. They can be purchased with a single payment to provide an immediate or deferred stream of income, or with a series of payments sufficient to provide a stream of income to begin at some future date. Annuities can provide income for the lifetime of an individual, or a joint-and-survivorship annuity can cover income for a surviving spouse or child, usually in a reduced amount.

Since annuities are related to life expectancies under a pooling principle, they are a form of insurance which requires application of underwriting techniques and the use of mortality tables. If an annuitant dies before the expected life span, the unused annuity amounts can be applied to payments for those living beyond their calculated life expectancy. The cost of an annuity is closely related to the age of covered individuals, but also depends on the projected investment return on amounts paid to the company (known as annuity considerations).

In 1989, U.S. life companies received $115 billion in annuity considerations, compared with $73 billion in premiums on life insurance policies. Individual annuities brought in $49 billion, of which $33 billion was from single-premium annuities which provide attractive tax advantages to the purchaser. By far the largest amount, however, came from group annuities related to pension plans, at $66 billion in 1989.

While a detailed examination of insured pension plans is beyond the scope of this paper, a review of some basic techniques may be helpful. A variety of arrangements between employers and insurance companies may be used, but the predominant methods today are the single premium deferred annuity and the deposit administration plan. Under the former, the employer purchases an annuity each year for each employee, sufficient to provide the pension which is due on retirement, usually dependent on length of service and salary level. At retirement, the sum of the annuity units purchased then determines the pension which the life company pays to the employee. In deposit administration plans, the employer sets

up a single fund for all employees eligible for a pension, which fund is then drawn upon to purchase an annuity for each employee at the time he retires.

It should be noted that some corporate pension plans are funded with bank trust departments or self-administered by the business firm itself. When an employee retires, a withdrawal is made from such funds to purchase the necessary annuity from a life insurance company; or, a lump-sum is paid to the employee which can then be used to purchase a life company annuity or invested directly by the retiree to provide retirement income.

For those who are self-employed, such as doctors, lawyers, and owners of small firms, special laws allow them to build pension benefits in other ways, broadly parallel to those available to employees of corporate businesses. Under the so-called Keogh Plans, a percentage of compensation up to a fixed dollar amount may be used to purchase retirement benefits from a life insurance company for the owner and his employees.

Another form of supplementary retirement income arises from "thrift plans" for employees, whereby voluntary contributions are made into a fund which is placed with an insurance company to earn tax-deferred interest or dividends, building savings that are not available to the employee until retirement but not before age 59-1/2. Such contributions, up to specified limits, are deductible from the otherwise taxable income of the employee. To encourage this form of thrift, employers often match the first two or three percent of salaries paid into the plan by employees. These tax-sheltered plans are known as 401(k) plans, 501(c)(3) annuities or 403(b) plans, referring to the sections of the Internal Revenue Code which authorized them, and they have become increasingly important in dollar volume over the past decade.

National policy to encourage retirement savings also created in 1981 a revised form of Individual Retirement Accounts (IRAs) by which working individuals could contribute to a retirement fund up to $2,000 from wages and salaries, and deduct such amounts from taxable income. Withdrawals were taxable as ordinary income although they could not be made until age 59-1/2 but could be deferred until age 70 while building up tax-deferred earnings on these assets. Since IRA contributions were not linked to employer arrangements, this form of retirement saving had the added advantage of complete portability for those who changed employers. In 1986, however, this legislation was changed to limit the arrangement to those employees not covered under an employer pension plan. Under the 1981-86 form of IRAs, contributions could be channeled into a variety of forms, including banks and thrift institutions, mutual funds, and brokerage accounts as well as life companies.

e. <u>Nonlife Insurance Lines of Business</u>

In addition to life insurance and annuities, many life insurance companies in the United States offer other insurance lines, notably health insurance and property and casualty insurance. Several leading companies, such as Aetna, Travelers, Nationwide and Allstate have long been engaged in selling automobile insurance, homeowners insurance and related casualty lines, while a number of larger life companies more recently have added such business lines to their operation by establishing subsidiary companies to supplement their traditional products and to diversify their operations.

Health insurance is offered by almost all of the larger life insurance companies, in competition with those companies that specialize in health insurance for individuals, business employees, and affiliation groups. Health insurance premium receipts of life companies totaled $56 billion in 1989, as

against $188 billion in receipts from life insurance and annuities. Reserves against health insurance operations, however. were less than 3 percent of total policy reserves of life companies and the generation of investable funds from health insurance is negligible.

Nonlife insurance lines are typically handled by subsidiary companies that are established or acquired under a holding company form of organization, which is widely permitted under state laws that govern company operations. In recent years, life companies have become interested in moving into other forms of financial services, including securities brokerage and underwriting, mutual funds, mortgage companies, real estate brokerage, real estate management, investment advisory services, and pension plan management. Several companies own savings and loan association subsidiaries, but life companies are barred by federal laws (and some state laws) from acquiring a commercial bank subsidiary. Similarly, under current law, commercial banks may not sell or underwrite insurance, except in a very few states where state-chartered banks have been allowed to sell insurance under laws enacted in the 1930s or 1940s and still in force. However, federal and state legislative proposals to remove the barriers between insurance and banking continue to be under active consideration in the United States at the present time.

f. Marketing and Distribution Systems

It has long been recognized that the sale of life insurance requires an aggressive marketing system, primarily because of the resistance of many individuals to contemplate the prospect of their own death, or to give up present income to provide for a hopefully distant event. It is often said that "life insurance is not bought, it must be sold". Because of the inherent complexity of the product, in the effort to meet the varying personal needs of individual customers, the sale of life insurance typically requires the use of face-to- face discussions between insurance salespersons and potential clients.

A variety of distribution systems are in use by U.S. life insurance companies to market their policies. These include the career agents, the general agents, insurance brokers, the mutual funds and securities dealers. In addition, mass merchandising through mail order and advertising in newspapers, magazines and television has become more important in recent years.

Career agents usually are employees of the company, responsible for managing an agency which recruits, trains, and oversees a number of salespersons. They receive salaries and normal benefits, but have no ownership rights in the agency. In contrast, general agents have rights to the agency business and they often are personal producers as active salesmen; they typically hire and train a small number of salespersons to supplement their own sales efforts. The exact responsibilities and compensation arrangements of career agents and general agents depend on the policies of the home office companies they serve, and no exact distinction between these two forms is feasible.

Insurance brokers, also known as independent life agents, do not serve a single company but normally place business with a number of different companies, depending on the product line involved. They often handle property-casualty insurance lines as well as life insurance and annuities. Also, since those salespersons who sell mutual funds and securities are in touch with clients with insurance needs, many of these individuals have become licensed to sell life insurance products as well. In fact, tax-sheltered annuities offered by life companies have became a particular speciality of brokerage firms and securities salesmen in recent years, dealing as they do with upper-income clients in higher tax brackets.

Mass marketing through direct advertising and mail-order is typically based on more simplified policy types than are handled by agents working on a personalized basis. Sales through affinity groups, such as college alumni associations or professional organizations has become more common, using master contracts with individual policies for purchasers. Insurance sold through mass marketing typically waives the need for physical examinations to screen for health problems, in contrast to the normal requirement for writing individual insurance. By trimming sales expense and administrative overhead, mail-order insurance is often available at lower premiums, though it is not able to tailor the policy to the particular needs of the insured.

Agents' commissions for life insurance typically involve a fairly high first-year commission, followed by stepped-down commissions for the successive three to five years of renewals. The logic of the renewal commissions is to provide an incentive for the agent to keep the policy in force, maintaining contact with the policyholder and providing whatever service may be needed. In most states, agents are strictly forbidden to rebate any part of their commission to the client, although anti-rebate laws have recently been challenged in court cases. Commissions usually differ according to the type of product sold (term vs. permanent insurance) and sales of group insurance receive a different commission structure from individual sales.

Agents' commissions are limited by state law in New York State, both as to first-year commissions and renewals. These limits also apply to the great majority of insurance sold, since companies that are licensed in New York State are not allowed to pay more than the stipulated commissions on policies sold in any other state in which they operate. A typical commission scale on cash-value life policies is 55 percent of the first year premium, followed by 10 percent in each of the next three years. For term life insurance, commissions are considerably lower. Prizes and bonuses for superior sales performance by agents are restricted to awards of low monetary value, so that regulatory limits on commissions are not circumvented.

III. FISCAL INCENTIVES

a. General Tax Principles

Life insurance and annuities sold both to individuals and to employers in the United States are greatly influenced by the tax treatment accorded such products under federal laws. It should be understood that the tax system applied to U.S. insurance policies may differ widely from that of other advanced nations, with the result that the relative attraction of a given product or contract in one country may not apply to a similar policy sold under another tax system.

Fiscal incentives for insurance products under U.S. laws and regulations are designed to serve well-recognized social and economic functions. To quote from a recent tax study by the U.S. Treasury Department:

> The principal justifications for the current tax treatment of life insurance and annuity products are to encourage the provision of financial support of dependents after the death of a wage earner, to allow protection against outliving one's assets, and to encourage private long-term savings[1].

In practice, the taxability of insurance products varies widely according to the nature of the product, whether it is purchased by individuals as life insurance or an annuity or by business firms as part of an employee pension plan. There are three basic issues of taxability in connection with insurance products. The first is concerned with whether investment earnings arising from such products should be exempt from tax, or taxed at some deferred time, or subject to immediate income tax along with other forms of income. A second tax issue applies to pensions and retirement savings plans, as to whether contributions to such plans may be deducted from taxable income, either by the employee or the employer. The third tax issue is whether federal estate taxes (as distinct from income taxes) are levied on proceeds from life insurance and from survivorship annuities.

b. Products Sold to Individuals as Insurance or Annuities

Death benefits from a life insurance policy are not subject to income taxes upon receipt by the policy beneficiaries. For this reason, investment income earned on most life insurance policies held until death is, in effect, exempt from federal income taxes. Under whole-life policies, where the interest earned on the accumulated reserves is built up over many years, the amount of investment earnings used to pay eventual death claims is considerable. But such earnings, known as "the inside buildup," escape payment of income tax entirely under U.S. law. Such treatment is in contrast to the taxability of current earnings on many other forms of long-term savings by individuals, e.g., corporate bonds or stocks, bank certificates of deposit, or U.S. Treasury bonds. Hence, saving through cash-value life insurance is often described as "tax advantaged".

Cash-value or permanent life insurance also has a clear tax advantage over term life. If an individual chooses to purchase term life, with a lower premium than cash value life, he could invest the difference each year in marketable securities, for example, and possibly earn more than the insurance

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[1] Department of the Treasury, Report to the Congress on the Taxation of Life Insurance Company Products, March 1990.

company is crediting on cash value policies. But the earnings on marketable securities are subject to income tax, year by year, while the inside buildup of earnings on cash value life is permanently exempt from income tax. That portion of market interest that is taxed away from the term life buyer cannot be reinvested to build up the investable principal. Hence, cash-value life has an obvious advantage over term life as far as taxes are concerned.

Endowment insurance, once a popular savings technique to accumulate funds for children's college education or for retirement, has declined sharply as an insurance product in recent years for tax reasons. Since 1984, the U.S. tax laws no longer consider most endowment policies as meeting the definition of life insurance; hence, interest credited to such policies is subject to income taxation year by year. Sales of such policies currently represent less than one half of 1 percent of new ordinary insurance sales.

If an individual withdraws part of his cash value prior to death, through a partial surrender or a policy loan, such moneys are likewise not subject to income taxation. However, if the amount of such withdrawals exceeds the cumulative premiums paid on the policy (net of policy dividends), then the excess amount is deemed to be taxable income arising from investment earnings. In this way, the tax law seeks to thwart an improper use of life insurance to avoid taxes on interest earnings, rather than its normal purpose to provide death benefits.

Death benefits are normally subject to federal (and state) inheritance or estate taxes, whether the policy is payable to an individual beneficiary or to the decedent's estate, so long as the decedent was considered the owner of the policy, with powers to change beneficiaries, surrender the policy, obtain loans, etc. In this regard, life insurance proceeds are taxed on much the same basis as other property or financial assets held by the deceased. This tax treatment also applies to group life policies provided by an employer, as a general rule. Under federal law, however, the first $600,000 of an estate is exempt from tax and the estate left to a spouse is fully exempt from tax. In practice, therefore, federal and state estate taxes are not a major source of government revenue. For very wealthy individuals, estate planning can minimize taxes through a variety of trust arrangements or shelters.

Income tax treatment of annuities is far more complicated than for life insurance, and there have been numerous changes in the Internal Revenue Code designed to prevent abusive use of individual annuities to escape or reduce income taxes. In general, the inside buildup of earnings on annuity contracts is deferred, but some part of annuity payments is usually subject to taxation. If loans are made from an annuity contract before scheduled distributions have started, such pre-annuity distributions are taxed to the extent of the inside buildup on the contract. When annuity payments are made, part is considered as a return of the policyholder's investments and is not taxed; the balance is viewed as investment earnings and is taxed as ordinary income. The underlying philosophy of the tax authorities seems to be that annuities should be allowed deferral of tax until payments start, but should not be manipulated in a way that provides undue tax advantages over retirement savings in such forms as bonds and stocks. Nevertheless, retirement savings are highly favored under the tax laws in order to achieve the objectives stated above.

c. Tax Treatment of Pension and Thrift Plans

For corporate employers, pension plans became a standard form of "fringe benefit" in the early 1950s, supplementing cash wages and salaries. The simplest example of a corporate pension plan is when the employer contributes the entire amount to the fund; this payment is considered a business expense

equivalent to wages and salaries and thus is fully deductible in the calculation of his taxable income. When the resulting pension is paid to the retired employee, such income is fully taxable under the income tax laws.

In other plans, the employee contributes toward the pension fund, while the employer usually contributes a portion as well. However, the employee's contribution is not deductible from his taxable income, i.e., he pays with after-tax dollars. When he receives his pension after retirement, only part of his payment is subject to income taxes, depending upon a calculation of the amount he has earlier invested in the plan through his periodic contributions.

Supplements to the basic pension system have grown rapidly over the past decade, largely in the form of employer-based thrift plans, sanctioned by Section 401(k) of the tax laws. Employee contributions to the retirement fund are deductible from taxable income up to specified percentages of income or dollar ceilings. Earnings on such funds, managed by life insurance companies and other fiduciaries, are tax-deferred. After age 59-1/2, the entire corpus of contributions and earnings can be withdrawn as a lump-sum subject to favorable income tax rates, or converted into an annuity on which normal income taxes are paid. In brief, the individual receives a tax break on money he places in the 401(k) plan, defers taxes on earnings, and withdraws retirement savings at a special tax rate for lump-sum distributions.

Individual Retirement Accounts (IRAs) are another form of retirement savings with tax advantages. Employees who have no pension plan with their employer may place up to $2,000 of earnings into an IRA with an insurance company, bank, brokerage firm, etc. and deduct such amounts from earnings in calculating their taxable income. No withdrawals are permitted before age 59-1/2 without substantial penalties, but after that age, full or partial withdrawals can be made with such amounts taxed at normal tax rates. As noted above, in 1981 these tax benefits were also made available to employees covered by employer pension plans, and this form of tax shelter was widely used by workers in all income groups. This privilege was withdrawn in the 1986 tax revision, largely to reduce the revenue losses that had resulted.

To encourage retirement savings by sole proprietors and business partners outside the corporate sector, tax laws in 1962 established so-called Keogh plans in which both employees and employers in such firms could deduct from taxable income their contributions to a retirement fund. Earnings were tax-deferred and withdrawals were prohibited until age 59-1/2. Broadly similar plans are also available to employees of nonprofit organizations of a religious, charitable, educational or similar purpose, to provide somewhat equal footing with corporate business employees. These are known as 501(c)(3) plans and 403(b) plans, referring to sections of the tax code. Such funds are managed by life insurance companies and other fiduciaries.

d. Group Term Life Insurance

Another common form of employee "fringe benefit" by business firms has been group life insurance which covers all employees, in amounts based on annual salary. For the employers, the premiums for such insurance are deductible from taxable income; for the employees, the value of premiums paid for insurance coverage up to $50,000 is not subject to income tax. For coverage beyond this limit, a calculation is made for the premium value of the additional amount of insurance and the employee is required to pay income taxes on this excess premium. Nevertheless, the employee normally

receives insurance at a cost (often zero) far below what he would pay for an individual policy with identical coverage.

e. **Further Observations**

Because life insurance and annuity contracts are infinitely variable in their structure and design, current tax laws and regulations are highly complex and the foregoing outline of tax treatment is far from complete. Broadly stated, the federal tax laws have provided substantial tax advantages to the various forms of retirement plans, largely by deferring taxes to be paid on income used to fund pensions and thrift plans or investment income earned on accumulated reserves. Investment earnings on traditional cash-value life insurance policies have been permanently exempted from income taxation, though proposals to remove this exemption have been urged on the Congress in recent years as a revenue measure to reduce budget deficits.

To avoid abuse of these tax privileges, the tax authorities have sought to distinguish between life insurance and annuity products sold for investment purposes as opposed to insurance protection or retirement benefits. Their approach has been to define tax-qualified life insurance as those contracts that provide for smaller investments or buildups of cash value than can be provided under a single premium policy. Because of the growing share of investment-oriented insurance and annuity products which emerged after 1980, closer scrutiny has been given to the characteristics of such products, to rule out those which involve an insufficient degree of pure insurance protection.

Within the life insurance industry, the tax-free "inside buildup" from investment earnings on cash-value life insurance is considered to be the keystone of their product lines, essential to the success of whole-life policy sales. Other product lines which involve tax deferral are important, of course, but not to the extent of whole-life policies which are marketed by virtually every life company in the business.

IV. INVESTMENT ASSETS

a. Guiding Principles of Investment Policy

Investment practices of life insurance companies are shaped by two key factors: the nature of the liabilities from insurance and annuities on their books, and the restrictions imposed by state insurance regulators on their investments.

As to the nature of liabilities, not all life insurance companies offer the same mix of product lines. Many larger companies provide employee pension and thrift plans, while a greater number do not. Some companies specialize in particular products, such as credit life or single-premium annuities, while others concentrate on traditional whole-life policies. Interest-sensitive products such as universal life were introduced by a large number of companies during the past decade, but many others have not attempted to market such policies. Because of this diversity in product mix, there is no typical or standard pattern for the range of company liabilities; consequently, there is no standard pattern for the mix of investment assets. In the Discussion that follows, industry totals and averages will be shown, but such data should not be taken as reflecting the practices of a typical or "average" company.

A fundamental principle of life company investment practices is the matching of assets and liabilities according to (a) duration or average life, (b) need for liquidity to meet possible withdrawals, and (c) earnings performance to maintain competitive position. In earlier times, when whole-life policies were the predominant product, death benefits were normally preceded by 30 years or more of premium receipts and reserves could be invested in long- term bonds or real estate mortgages with maturities of 25 or 30 years. The net inflow of premiums, augmented by investment income and amortization, normally exceeded the outflow of death benefits so that total assets were constantly rising and the need for liquidity was small. In contrast, many of the investment-oriented products marketed in the last decade have shorter duration and require greater liquidity than was needed in earlier years.

Asset/liability matching today often involves setting up a series of segmented asset accounts or portfolios, with each account designed to stand behind a particular class of policies or product line. Thus, the portfolio mix assigned to the universal life policy line would require shorter maturities and more liquid assets than those used to back traditional cash- value life policies. In the case of employee thrift plans, where funds can be readily switched on short notice to another carrier, it would be unwise to invest incoming funds in longer-term securities. Moreover, such thrift plans often allow the individual participants to redirect their funds between fixed-income accounts and equity accounts at any time, so that the uncertain duration of such money requires readily liquifiable investments. Corporate pension plans have made increasing use of guaranteed investment contracts (GICs) which specify a fixed period of three to five years before withdrawal or renewal; investment of such funds by the insurer must take account of the probable duration of the arrangement. Close working relations between investment officers and marketing executives have become essential to developing the appropriate match for maturities, risk elements, liquidity and investment yield.

State investment laws have clearly shaped the investment policies of life companies, by setting forth quantitative limits on the percentage of assets permitted in various forms, and by requiring minimum credit standards on permitted investments. Although these laws differ in their specific content from state to state, they have focussed on the diversification of assets among permitted investment outlets, along with qualitative standards for the safety of principal amounts invested. Further description of these state

investment laws is presented in the sections below, which outline activities in each of the major investment markets in which life companies operate.

b. Life Insurance Industry Mix of Assets

At the end of 1990, U.S. life insurance companies held total assets of $1,408 billion, an increase of 8.6 percent in that calendar year. By far the largest investment category was corporate bonds of $536 billion, or 38 percent of total assets. Real estate mortgage loans, largely on commercial properties, totalled $270 billion or 19 percent of total assets, while directly-owned real estate was $43 billion or 3 percent. Life company holdings of U.S. Treasury and federal agency securities represented another 13 percent of assets or $176 billion. Corporate equity holdings, common and preferred, aggregated $129 billion or 9 percent of total assets. Short-term commercial paper held for liquidity purposes accounted for another $41 billion or 3 percent of industry assets.

Investments in securities of foreign governments and international agencies have always been small, partly because of legal restrictions but primarily from lack of familiarity with these markets. At year-end 1990, such holdings were $17 billion or just over one percent of total assets. Investments in foreign corporate debt obligations, both long- and short-term, were $32 billion or 2 percent of industry assets, of which a major share was in Canadian securities.

Policy loans make up another 4 percent of industry assets, or $62 million. Such loans are taken at the option of the policyholder, as provided in cash-value life contracts, and they often are at below-market interest rates, particularly if an older policy is drawn upon. While policy loans are considered invested assets, they are not initiated or welcomed by investment officers who would prefer to place funds in more profitable outlets.

In the sections that follow, the role of the major investment outlets will be examined in greater detail, including the characteristics of such investments, the investment laws that affect these investments, and recent trends in the relative importance of such assets in company portfolios.

c. Corporate Debt Obligations

Corporate bonds, notes and debenture have been for many decades a leading investment medium for life insurance companies. During the 1920s and 1930s, the main focus was on obligations of railroads and public utilities which were considered at the time to have the safest capacity for debt service. The economic expansion following World War II brought major financing demands from industrial corporations and life companies provided a major share of the long-term financing sought by these firms to expand their plant and equipment. By the 1960s, life companies also had become major suppliers of financing for oil and gas pipelines, jet aircraft, and other transportation equipment, responding to market developments among new industries in the postwar years. Currently, the largest category of bondholdings is "finance", which includes mortgage-backed securities as well as issues by various financial institutions. The manufacturing sector occupies second place, followed by bond issues of public utilities in the third largest category.

Life companies have developed a lending technique known as "private placements" wherein a borrower deals directly with the provider of long-term finance, by-passing the public issue market which relies on investment bankers to distribute the securities to a variety of investors. Because of their size,

larger life companies are often in a position to take the entire issue of a corporate borrower, rather than a portion of a public issue sold through investment bankers. Moreover, private placements allow borrower and lender to negotiate the specific terms of a tailor-made indenture satisfactory to both parties. This technique also saves the costs of preparing prospectuses, registering the issue with the Securities and Exchange Commission, and paying commissions to the underwriters--making the loan less expensive than a public issue. Through the 1960s and 1970s, life companies acquired 75 percent or more of their corporate bond investments through private placements. In the 1980s, however, the share of private placements fell off sharply, as the need for marketability of assets shifted acquisitions toward public issues. By the end of 1990, only one third of corporate bond holdings of life companies were private placement issues.

Because of their positive cash flow of investable funds in the 1950s and 1960s, life companies had an added advantage over the public issue market--the use of "forward commitments" to deliver borrowed funds at future dates. Many borrowers needed to contract for new factory projects many months or years in advance and to work out the necessary financing at assured rates and terms. Life companies were able to deliver loan proceeds six months, twelve months, and eighteen months after the loan agreement, if that suited the needs of the borrowers. For example, if a new factory or a large shopping center was being built, the borrower would obtain interim construction financing from a bank; upon completion of the project many months later, permanent financing from a life company commitment would pay off the construction loan with a 25-year debenture.

In the early 1950s, life insurance companies owned over 60 percent of the corporate bonds outstanding in the United States. This percentage began to decline in subsequent years, however, primarily because of the rapid growth of state and local government retirement funds and noninsured pension funds, which strongly favored corporate bonds as an investment outlet. By the mid-1970s, the share of outstanding corporate bonds held by life companies had declined to about 33 percent, and that share continued to prevail in the late 1980s.

A major shift change of the past decade has been the new emphasis on public issues of debt securities. Unlike private placements, for which a secondary market barely exists, public issues can be resold from portfolio with much less difficulty. This became an important consideration for portfolio managers after 1980, when liquidity gained higher priority for two reasons. First, the industry had experienced a drastic liquidity squeeze in 1980-1981, when policyholders demanded policy loans and/or surrendered their policies to place the proceeds in marketable instruments with double-digit yields. Second, the introduction of interest- sensitive insurance products after 1980 led to greater uncertainty about interruptions of premium inflows along with potential withdrawals, leading companies to adopt a protective stance with higher liquidity ratios. In practice, this brought about a new emphasis on resalable public issues along with a shortening of original maturities from around 20 years to about half that duration.

Investment laws of the various states also influenced the investment by life companies in corporate debt obligations. The most important state on investment matters has been New York, where many companies wished to sell insurance because of the large and prosperous population. In order to sell insurance in New York State, it was necessary to "comply in substance" with New York investment laws, even if the company were domiciled in Ohio, Massachusetts, Connecticut or some other state. Under the New York State investment requirements in force during most of the postwar period, corporate bonds were required to pass several eligibility tests. Earnings to service the debt must have been available for the past five years, and the issuer's net earnings must equal at least 1-1/4 times the annual fixed charges.

The eligible bond could not be in default as to principal or interest, and the obligation must have been adequately secured, with characteristics wherein speculative elements were not predominant. In addition to these "qualitative" restrictions on life company investments, the states have normally imposed a variety of "quantitative" limits based on percent of total assets and/or percent of capital and surplus, For example, in New York, no more than 5 percent of insurance company assets could be invested in the bonds of any one issuer, in order to ensure diversification of holdings. Other states imposed limits on the percent of assets held in the bonds of railroads or public utilities, rather than corporate obligations in general. Over the years, some of these limits have been liberalized by many of the states. But when New York State in 1983 replaced its lengthy and detailed "qualitative" rules with a more general "prudent individual" rule, it still retained most of the "quantitative" limits to ensure diversification of the investment portfolio.

In 1987, the New York insurance department became concerned over the heavy investments by some insurers in so-called junk bonds sold in connection with business take- overs and leveraged buyouts. To limit company exposure to such issues, New York imposed a new limit of 20 percent of assets in "high-yield high-risk" obligations publicly traded or issued in a leveraged buyout. This limit was applied more broadly in 1991 to include medium- grade bonds (rated Ba) and private placements previously outside the limit. Within the 20 percent cap, "inside limits" of 10 percent, 3 percent and 1 percent were imposed on lower grade bonds, effective in 1992. Other states have introduced legislation to impose somewhat similar limits on bonds below investment grade, in the effort to avoid insurer insolvencies arising from the recent decline in junk bond prices.

Another form of regulatory influence on the management of corporate bond portfolios has been the Mandatory Security Valuation Reserve (MSVR) which is required of companies in all of the states. The MSVR serves as a loss reserve to buffer company surplus against bond defaults and declines in market values of corporate debt issues. The formula for company contributions to the MSVR is based on the credit quality of each bond, which is reviewed every year by the Securities Valuation Office of the National Association of Insurance Commissioners (NAIC), a central organization of all the state insurance departments. A minimal contribution of 1/10th of one percent is required against higher-grade bonds (A-rated or better), scaled through the quality grades to Caa or lower which must credit the MSVR with 5 percent of the par value of such holdings. If a bond goes into default or is sold at a loss, such losses are charged against the MSVR rather than surplus. In effect, the MSVR system serves to penalize the acquisition of lower-grade corporate issues, by requiring transfers to the reserve at the expense of current company surplus.

It is important to note that bondholdings of life insurance companies are carried on their annual statements at stabilized values, rather than current market values, unless an issue goes into default. This rule, promulgated by the NAIC many years ago, is based on the concept that bonds are normally held to maturity and should not be marked up or down each year according to changes in market interest rates that are beyond the control of the investing company. Also, if assets are "marked to market" reflecting interest rate swings, it is argued that liabilities should also be marked to market--leading to much confusion by policyholders and regulators alike. Only when a bond is sold or near default is the market value recognized in the company accounts, reflecting the view that market value is appropriate to a liquidation situation, not to going-concern valuation.

d. Corporate Equities

Common and preferred stocks have never been a major investment medium for life insurance companies, nor have the life companies played a major role in the stock market. At the end of 1990, life companies held $119 billion in common stock and $10 billion in preferred stock, representing 9 per cent of total industry assets. Of these amounts, $59 billion was held in the general accounts of life companies, corresponding to 4.7 percent of general account assets. Another $69 billion of common and preferred shares was held in the segregated accounts established separately for pension customers who bear the risk of market fluctuations. Only 3 percent of the outstanding common stock of U.S. corporations is currently owned by life insurance companies.

The reason for this modest interest in common stock arises in large part from the general view that stocks are a riskier investment medium, often with speculative elements not appropriate for life insurance companies. Indeed, the influential New York investment laws prohibited the acquisition of common stock until 1951, when up to 3 percent of company assets was authorized as a maximum. (Several other states had more liberal ceilings for common stock, often as high as 10 percent at that time.) The New York limit was raised to 5 percent of assets in 1957 and further increased to 10 percent in 1969. Other quantitative limits applied as well; in 1951, a life company could not acquire more than 2 percent of the outstanding shares of any single corporation (raised to 5 percent in 1969). Also, only 0.2 percent of assets could be invested in a single corporation in 1951 (raised in a series of changes to 2 percent at present). The current limit on total holdings of common shares is 20 percent of assets under New York law.

These tight investment limits created problems for life companies in meeting the demands of pension customers, who wished to share in the substantial market appreciation of common stock during the 1950s. These customers turned to the trust departments of commercial banks to handle their pension moneys, with instructions to place major proportions in the rising stock market. In order to compete for such funds, life insurance companies sought to establish "separate accounts" outside the general account of the company itself and, most importantly, without the quantitative limits imposed on companies by state investment laws. Beginning in 1959, the state laws were rewritten to permit separate accounts to hold as much as 100 percent in common stock if the customer so desired. However, any gain or loss (realized or unrealized) on such accounts was credited or charged to the customer, and not to the general account of the life company.

At first, separate accounts were solely for group pension plans, but state laws later permitted their use for both group and individual contracts, including variable annuities and variable life policies. At year-end 1990, separate accounts held $160 billion in assets, about 11 percent of total industry assets; less than half of this amount is presently in common stock, with the remainder in bonds, mortgages, real estate and other invested assets.

In contrast to the stabilized statement values of corporate bonds, common stock held in the general accounts of life companies is carried at market value. Thus, fluctuations in stock prices can produce large gains or losses for life company financial statements, introducing an element of risk which many companies avoid by owning little or no stock. Downturns in stock prices can produce incursions into capital and surplus, and this took place for many companies in the 1973-74 period, when stock prices lost 45 percent of their previous peak values before rebounding in 1975-76. Volatility of this type is still an unwelcome feature in the portfolio policies of many life companies, even though long-run gains may outstrip the earnings on corporate bonds.

The MSVR described above for bonds is also used to cushion the fluctuations of common stock, though in a somewhat different fashion. Life companies are required to place the realized and unrealized gains from common stock holdings into the MSVR until the reserve reaches a maximum of 33-1/3 percent of holdings; thereafter, gains may be credited to company surplus. Conversely, any losses on common stock are first taken against the MSVR and when that reserve is exhausted, charges are made against company surplus. In this way, the surplus account is cushioned against a large share of fluctuations in stock prices.

e. Commercial Real Estate Mortgages

Because mortgage loans traditionally have had maturities of 20, 25 or 30 years, they have always been viewed as an ideal investment medium for the long-term obligations of whole-life policy reserves. At the end of 1990, mortgage holdings were $268 billion or 19 percent of total industry assets. The bulk of such holdings (about $200 billion) was in the form of mortgages on commercial real estate such as office buildings, shopping centers, industrial warehouses, hospitals, hotels and resort properties. Other mortgage operations include loans on apartment dwellings, single-family homes, and farm properties.

For the first 25 years after World War II, life insurance companies held first place as the largest institutional lender on commercial properties, and they have continued to provide between 25 and 30 percent of commercial real estate financing in the United States. In the 1950s, lending to finance retail stores and new shopping centers was the main thrust of life company activity, providing the support services for new community development based on the sharp upturn in homebuilding. The focus shifted toward office buildings in the late 1960s and early 1970s, but retail store financing again has become the largest single form of commercial mortgage lending by life companies in recent years.

State investment laws governing mortgage lending by life companies have followed a conservative course, limiting mortgage loans on commercial properties to 66-2/3 percent of appraised value until 1964 when New York State raised the permitted loan-to-value ratio to 75 percent. Many states impose quantitative limits on total mortgage loans held by life companies; the percentage in New York was 40 percent until it was lifted to 50 percent of assets in 1964. More common was the legal limit on lending on any single parcel, usually 2 percent of assets but sometimes a percentage related to capital and surplus. Such restrictions apply to any form of mortgage lending, and not just to commercial mortgages. The current New York limit stands at 2 percent of assets on a single property, but other states are sometimes higher.

Commitments on commercial mortgages are usually made in advance of construction, with funds paid in installments as the work is completed, and proceeds used to repay short- term construction loans from commercial banks. Loan maturities normally ran in the 20- to 25-year range until recent years, when liquidity considerations led life companies to limit the bulk of their commercial mortgage lending to 10-year maturities.

f. Residential Mortgage Lending

In the years immediately following World War II, life companies became important lenders on home mortgages, financing a large share of the postwar boom in housing construction. The primary outlets were mortgages insured by the Federal Housing Administration (FHA) or loans guaranteed by the Veterans Administration (VA). Along with the safety of government backing, these loans commanded attractive yields for the time. Conventional home loans, i.e., those without government guarantees, were

also made in volume to finance apartment houses as well as single-family homes. By the mid-1960s, the life insurance industry held 15 percent of the outstanding mortgage loans on residential properties in the United States.

Under state investment laws, the maximum 66-2/3 loan-to-value ratio on mortgage loans was waived for FHA and VA mortgages, thus allowing life companies to operate in those markets along with other institutions. But the limit hampered activity in conventional home loans until 1959, when New York and other states lifted the loan-to-value ratio to 75 percent, but only on home loans amortized in 30 years or less, in amounts of $30.000 or less. Not until 1974 was the maximum lifted to 90 percent of appraised value, to keep life companies in step with other institutional lenders.

In the late 1960s and 1970s, however, investment yields on corporate securities became more attractive than for home loans, and life companies moved away from the single- family mortgage field which was being supplied by the depository thrift institutions that specialized in home mortgage lending. Consequently, the current holdings of home mortgages by life insurance companies are quite small and only a few companies are still active in making home loans.

In the late 1970s, however, life companies re-entered the home mortgage market in an indirect fashion--purchases of "mortgage-backed securities" which had been developed as a new capital market instrument. Under this arrangement, a mortgage originator such as a savings and loan association or commercial bank packages a large number of home loans into a portfolio which is "securitized" and sold to other investors such as life companies. Interest and amortization from the underlying mortgages is passed through monthly to the owner of the mortgage-backed security, including any prepayments. In addition, such quasi-governmental agencies as the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) purchase large amounts of mortgages in the secondary market in order to repackage them as mortgage-backed securities to be sold to various investor groups.

Holdings of various types of mortgage-backed securities by life insurance companies have grown rapidly, currently exceeding $150 billion. In this way, life company investment funds continue to finance the construction of single-family homes.

g. <u>U.S. Treasury Securities and Federal Agency Issues</u>

At the end of 1990, life insurance companies held $59 billion in direct and guaranteed obligations of the U.S. Treasury and $121 billion in issues of various federal agencies. Taken together, these holdings represented 13 percent of total industry assets. While these securities are of the highest investment quality--superior to any corporate issue- -they carry the lowest interest rates within life company portfolios.

Life company attraction to Treasury and agency issues has developed only in the past several years. In the mid-1970s, such holdings were 3 percent or less of total assets, as the higher yields on corporate issues and mortgages attracted the bulk of available funds. The recent interest in Treasury and agency issues is explained by two factors. First is the need to hold a larger share of absolutely safe assets to counterbalance the riskier, high-yield bonds and mortgages that were acquired in the 1980s. The second factor is the need for greater liquidity, to match the potential for withdrawals and surrenders from the new product lines of interest-sensitive policies. In contrast to the traditional holdings of private-placement bonds and commercial mortgage loans for which there is no organized resale market,

Treasury and agency securities are highly liquid, resalable in a broad secondary market where large quantities can be liquidated without depressing prices. Moreover, Treasuries can be bought with much shorter maturities so that the interest-rate risk of volatile market prices is minimized.

Because they are recognized as the safest investments in the marketplace, Treasury and agency issues have never been restricted in state investment laws, nor have security reserves been required against such holdings under the MSVR rules outlined above. It is noteworthy, moreover, that purchase of Treasury securities by life insurance companies has never been mandated in the United States, either by state law or by the federal government.

h. State and Local Government Securities

In the United States, interest income from obligations of state and local governments and the agencies authorized by these political units is not subject to federal income taxes. Since these tax-exempt issues are highly attractive to investors in the higher tax-rate brackets, borrowing costs of state and local governments are kept lower than for other issuers whose interest payments are taxable to the recipient, usually running around two percentage points lower for bonds of comparable quality ratings.

Life insurance companies as a general rule have had little attraction to the tax-exempt issues of state and local government units, primarily because of the way in which life companies themselves have been taxed over the years. At the end of 1990, life companies held less than $10 billion in such obligations, equal to less than one percent of total assets.

i. Investment Real Estate

Through their role as lenders on commercial real estate, life companies became more familiar with the operational and management aspects of such properties and decided to make direct real estate investments in addition to mortgage loans. As direct owners, they stood to benefit from increased market value of an office building or shopping center, as opposed to being fixed-rate lenders to developers who reaped the profits from later appreciation in property values. Accordingly, a number of the larger life companies became active as developers, managers and owners of many types of real property. In recent years, real estate holdings have amounted to more than 3 percent of total assets, for a dollar total of $45 billion at the end of 1990. About one eighth of this amount represents the value of insurance company head offices and branches used for their own operations.

Investment laws limit the ownership of real estate, as with other invested assets. Under New York law, a company cannot own more than 2 percent of assets in any particular property, or more than 20 percent of assets in real estate held for investment purposes; however, up to 10 percent of assets can be devoted to company-used properties so long as total real estate holdings do not exceed 25 percent.

j. Foreign Investments

Investments in obligations or equities issued by foreign governments or nationals have been severely limited by state investment laws for many years, presumably because of the risks of exchange fluctuations, expropriations, or wars in addition to the difficulties of monitoring such investments. However, a number of larger companies have engaged in lending abroad, though in relatively minor amounts.

At the end of 1990, the life insurance industry held $27 billion in foreign corporate bonds, $5 million in foreign commercial paper, and $17 billion in obligations of foreign governments and international agencies. Taken together, these holdings represent about 3.5 percent of total industry assets. Although breakdowns are not available, a large share of these amounts is known to be invested in Canada, where U.S. life companies are often licensed to sell insurance and annuities and are required to invest part of their consequent reserves.

Canadian investments are favored under investment limits of many states. New York State permits up to 10 percent of assets in Canadian investments of all kinds, while investments in other foreign countries are subject to an overall limit of 3 percent of assets with no more than 1 percent in a single country.

k. Policy Loans

While loans to policyholders are earning assets of life insurance companies, they are not considered investments in the strict sense. Rather, they represent borrowings on the cash value of a policy, made at the request of the policyholder and carrying a specified interest charge. At the end of 1990, policy loans represented 4.3 percent of total industry assets, for a total of $62 billion.

The basis of policy loans arises from the life insurance contract for whole-life policies which, under the mandate of state insurance laws, allows the policyholder to borrow up to a high percentage of his cash value. The interest rate for such laws is also specified in the contract, with such rates fixed at either 5 percent or 6 percent in policies issued before the early 1970s. When market interest rates rose well above these levels, it became advantageous for policyholders to access their policies at these favorable rates, either as an alternative to borrowing elsewhere or to reinvest the loan proceeds in higher-yielding market securities.

One result of these provisions was repeated drains on life company investable funds, whenever market rates rose above the fixed policy loan rates. Such withdrawals thereby precluded the companies from using such funds for investment in bonds and mortgages at the higher prevailing yields, thus reducing overall investment returns. For some companies, sudden drains from policy loans interfered with their ability to honor forward commitments to take down private placements and mortgage loans scheduled in advance. To correct this situation, the industry persuaded insurance regulators to permit a flexible system of policy loan interest rates, linked to a moving index of bond yields rather than fixed contractual rates. This allowed the policyholder to obtain funds if needed, but prevented interest arbitrage for such borrowings when market yields surged to higher levels.

l. Rate of Net Investment Income

The earnings rate on life company assets reflects the interest rates trends in the capital markets, but with a time lag because the bulk of such assets represent longer-term investments acquired in previous years. In 1980, the rate of net investment income for the industry stood at 8.02 percent; by 1985 this figure had risen to a peak of 9.63 percent, reflecting the high rate level on new investments made in the intervening years. Over the next five years, however, the earnings rate declined steadily, falling to 8.89 percent in 1990. This rate refers to investment income after investment expenses and depreciation, but before federal income taxes; it excludes capital gains and losses.

The rate on general accounts typically runs higher than for separate accounts, largely because the latter has a high proportion of common stock paying lower current dividends (but with a substantial potential for capital gains excluded from the calculation). In 1985, the general account earnings rate was 9.87 percent, declining to 9.31 percent in 1990. Because industry assets are largely invested in corporate debt obligations and commercial real estate mortgages, these earnings rates run higher than the rates available on U.S. government bonds, but they obviously involve a higher risk element than on Treasury and agency security issues.

V. REGULATION

a. Overview of Regulatory System by State Governments

In the United States, regulation of insurance companies is reserved to the several states, rather than the federal government. The origins of this system date back to the early 1800s when insurance companies were first coming into existence; the first supervisory boards were established in the New England states in the 1850s. New York State was the first to appoint a full-time insurance commissioner, in 1859. By 1871, state insurance regulation had evolved to the point that an organization was formed of insurance supervisors of the several states, now known as the National Association of Insurance Commissioners (NAIC), to promote and encourage uniformity in laws and regulations affecting insurance.

For several decades, according to court rulings, the sale of insurance was considered "not a transaction of commerce" and therefore outside the powers of the federal government in its regulation of interstate commerce. In 1944, a Supreme Court ruling stated that insurance sold across state lines was interstate commerce and subject to a variety of federal statutes; however, a federal law (known as the McCarran-Ferguson Act) was passed the following year which assured the existing state powers to regulate insurance, rather than allowing federal government agencies to take on regulatory powers over insurance. That law remains in force to the present time.

The primary objective of insurance regulation and supervision is to protect the interests of the insurance buying public. This responsibility is carried out in two ways: first, to determine that policyholders and beneficiaries are given fair and reasonable treatment by insurers and insurance agents; and second, to ensure the financial soundness of insurance carriers and the capital, reserves and invested assets held for the distribution of benefits. The following sections spell out in some detail the means by which state insurance regulators seek to meet their objectives.

b. Organization of State Insurance Departments

Insurance departments of the 50 states and the District of Columbia are organized as agencies within the executive branch of state government, with powers and duties normally specified under the insurance code passed by the state legislature. Such departments are headed by a superintendent or commissioner of insurance who is usually appointed by the governor of the state; in twelve states, however, this official is elected by state voters. The commissioner is typically given power to make rules and regulations to carry out provisions of the insurance code, often with quasi-judicial powers to hold hearings on insurance matters.

Funding for insurance departments is usually provided from the general revenues of the states, as appropriated annually by state legislatures for operations of the executive branch. Such moneys are used to engage professional staff such as lawyers, actuaries, and financial examiners to carry out the assigned duties of the department. The size of departmental staff varies widely among states, depending on the number of insurance companies for which the state has responsibility and the size and complexity of such companies. Hence, the staff size varies from about 100 in some smaller states to several thousand in New York State.

c. Chartering and Licensing of Companies and Agents

A primary power of insurance departments is the chartering of insurance companies incorporated in their respective states as "domestic insurers." The code typically specifies the minimum capital and surplus needed by a stock company and the minimum surplus required of a mutual company. The most stringent requirement, in New York State, calls for $1 million in capital stock and $2 million in surplus for a total of $3 million. Standards for forming a mutual company in New York are equally stringent and no new mutual insurers have been incorporated there for several decades. In other states, chartering standards are not as stiff; initial capital can be as low as $350,000 in some western states so that the number of new incorporations is considerably higher. The insurance codes often require that organizing directors and officers be of good character with proven business capabilities. The charter then issued often specifies which classes of insurance may be underwritten by the company, and which lines (such as health insurance or casualty insurance) may only be written through a subsidiary.

In addition to chartering, insurance departments are charged with the licensing of insurers, both domestic and out-of-state companies, with renewals of such licenses subject to compliance with a wide range of state standards, including filing of annual financial statements, observance of investment laws, etc. Without such licenses, companies from other states (called foreign insurers) are not permitted to sell policies to state residents, except for mail-order insurance which many states now permit. In this way, each state is able to exercise a strong degree of control over the operations both of domestic companies and of out-of-state and alien companies admitted to do business in the state.

A related control element arises from licensing of insurance agents and brokers, which is usually specified by insurance law. To obtain a license, the applicant must show that he has been certified by an insurance company as to his honesty and competence, and he must pass whatever tests of competency are required by the insurance commissioner. The license may be revoked or suspended if the agent willfully violates insurance regulations, or conducts fraudulent practices, or is proved incompetent. Licenses are usually perpetual, but sometimes renewal fees are required. Separate licensing is often required for sales of health insurance, a product line carried by many life insurance companies. If the agent wishes to sell variable annuities or variable life (investment products regulated by the Securities and Exchange Commission), he must also obtain a special federal license upon passing prescribed examinations. Some states also issue limited licenses which permit only the sale of credit life insurance.

d. Approval of Contract Forms

A key element of consumer protection by state regulators is the control over authorized contract forms for policies sold to residents of the state. As new versions of life insurance and annuities are developed within companies, the policy provisions must receive the commissioner's approval before they can be offered to the public. Regulatory review is designed to exclude ambiguous language and to prevent unfair or deceptive practices, in the effort to protect policyholders and beneficiaries. The commissioner usually is empowered to disapprove policy forms that are contrary to any provision of state laws or regulations, or are deemed to be unfair, inequitable or misleading to the policyholder.

Standard policy provisions required under the insurance laws of most states commonly deal with such matters as grace periods for premium payment; incontestability; nonforfeiture benefits and surrender values; policy loans after three years; and a variety of other legal rights. Where group life insurance is involved, state laws also require the policy to provide for conversion privileges on termination of employment or on termination of the master policy.

e. Life Premiums and Policy Reserves

Premiums on life insurance policies are not directly regulated by the state authorities, but the regulation of reserve liabilities provides an indirect regulation of premiums charged to the consumer. States typically prescribe the basis for calculating minimum reserves, in terms of mortality tables to be utilized, maximum interest rate assumptions, and the valuation method to be used. Regulation is aimed primarily at the adequacy of reserves, and companies are allowed to adjust their reserve calculation to provide higher reserves, so long as the minimum reserve standards are satisfied.

Statutory requirements for reserve calculations, along with statutory limits on commissions and expenses on new policies, are generally seen as ensuring that adequate premiums are charged, while it is felt that competition among companies provides a safeguard against excessive premium rates. The net cost of insurance is also dependent on the level of policy dividends paid on participating policies of stock companies and on all policies of mutual insurance companies. Such dividends are paid to policyholders when investment income and mortality experience generate an excess in company earnings; to ensure such payouts, some states have surplus limitation laws designed to prevent the accumulation of excess earnings by the company beyond certain levels.

To assist consumers in comparing costs of similar policies offered by different life insurance companies, many states require that buyers be furnished with indexes showing the surrender value of different policies at a future date and the death benefit payable at an assumed point in time. These interest-adjusted cost comparison data have been distributed in "buyers' guides" for life insurance products since the mid-1970s, but there continues to be concern about the adequacy of consumer information for the average buyer.

Insurers are allowed, within limits, to classify policy applicants by risk and to charge different premiums accordingly. The age of the applicant is an obvious variant which requires a higher premium at higher ages because of life expectancies. Since women have longer life expectancies on average, rates charged to them are typically lower than for men, though at least one state (Montana) requires unisex rates to avoid such discrimination. Many states permit lower rates for non-smokers. Those in high-risk occupations or with risky avocations such as airplane piloting can be charged higher premiums. Applicants with known health problems can be required to pay higher premiums by reason of known risk factors. Also, policies in some states can contain a war-risk clause, waiving death benefits if death results from war, since life expectancies cannot be factored in to mortality calculations in such an event.

On the other hand, many states prohibit risk classification arising from race, religion or national origin. A current controversy relates to an insurer's right to test applicants for the AIDS virus, which many companies insist upon to protect against adverse selection by those who foresee imminent death from that disease.

f. Regulation of Investments

Illustrations of the investment laws governing life insurance companies have been given in the earlier section on company activities in the capital market, but a few general observations may be in order at this point.

The general philosophy behind the state investment laws is that insurers must remain in sound financial condition, to protect the interests of the insurance buying public. Toward this end, safety of

principal is the foremost consideration; undue risk is to be avoided, even though this implies a sacrifice of potential investment earnings that could be realized from assets involving greater risk.

To minimize risk, investment laws in some states set forth a number of prohibited investments; other states use specific lists of permitted investments. Diversification of asset types is another common requirement, not by requiring certain asset shares in particular forms, but by limiting the percentage of assets held in certain forms, e.g., mortgage loans, or common stocks, or bonds of a single issuer. Such percentage restrictions are termed "quantitative limits" and are widely used in the investment laws of most states.

Another type of restriction is through "qualitative limits" related to the quality of the eligible investment. For example, the earnings of a corporate bond issuer must equal a certain ratio to the interest charges on outstanding debt; or the mortgage on real estate cannot exceed a specified percentage of appraised value; or, the common stock must be traded on a national exchange with a record of paying dividends for the previous three years.

In practice, the quantitative and qualitative limits on investments prevented life companies from going into new investment forms which emerged during the postwar years, since they were not on the permitted list. To provide for some relief from these constraints, and to leave room for innovation and flexibility, several states including New York approved "leeway clauses" in their investment laws, permitting a certain percent of assets to be invested in forms not otherwise specified. The initial percent in New York was 2 percent of assets in 1958, raised in later years to 5 percent and then to 10 percent at present. The use of "leeway clauses" allowed companies to enter such new fields as equipment leasing, oil and gas pipeline finance, and a variety of novel financing techniques. It also allowed companies to exceed normal quality limits, such as the 75 percent loan-to-value ratio on commercial mortgages, by "spilling over" any excess into the leeway category.

As noted earlier, the specific requirements and limits in state investment laws vary widely among the several states, and cannot be easily summarized. However, the importance of New York State investment laws (frequently cited in this paper) has been a major factor for most companies, since the companies licensed in New York are required to "comply in substance" with these laws, even though they may be domiciled in other states. It has been estimated that companies doing business in New York State, and subject to these laws, account for 70 percent of total sales of life insurance throughout the United States.

After several decades of imposing the most restrictive investment standards of any state, the New York legislature in 1983 made a major change in its investment statutes. In place of highly detailed quality tests and eligibility standards, often running on for many pages for each type of investment, the new legislation substituted a broad standard generally known as the "prudent man" rule. The amended law stated that life company investments should be made "with that degree of care that an ordinarily prudent individual in a like position would use under similar circumstances." It should be noted, however, that most of the quantitative limits on percentages of assets, contained in another section of the New York State law, remained in force.

g. Submission of Financial Statements

The financial condition of life insurance companies is reviewed by state regulators in a variety of ways, but the primary document is the annual statement to be filed with the insurance department of

every state in which the company does business. The format of such statements, known as the convention blank, is universal within all states under rules developed by the NAIC to provide uniformity.

The convention blank resembles the usual corporate financial statement in some respects, but is designed primarily to describe operations peculiar to insurance companies. The balance sheet shows assets and liabilities; a "summary of operations" is similar to an income statement. The surplus account shows sources of funds from amounts carried over from the previous year, net gains from operations, and net capital gains; uses of funds are dividends to stockholders, increases in surplus, and net capital losses. Further exhibits show the contributions to surplus from each of the main insurance lines (ordinary, group, health, credit); the reserve section shows additions to reserves from assumed net premiums and interest, from which assumed mortality, termination payments and other costs are then subtracted to show reserves at year-end.

Among the several other exhibits detailing company operations are the lengthy schedules for company investments, listing every asset acquired in the year and every bond, stock, mortgage, etc. held at year-end. Other schedules show the compensation paid to company officers and employees above certain amounts, and a report of proceedings of the latest annual meeting of the company.

To guard against fraud or concealment, state regulators in recent years have begun to require that such financial statements be reviewed by independent auditing firms and certified as to their completeness and correctness. Many mutual companies, in addition to the statutory accounting required by the states, have begun to have their financial statements recast according to Generally Accepted Accounting Principles (GAAP) in keeping with most other corporations in the business community. It may be noted that stock companies, in accordance with SEC requirements, file GAAP financial statements both quarterly and annually with the federal authorities.

In the schedules relating to invested assets, the current valuation of bonds, preferred stock and common stock is determined by the Securities Valuation Office (SVO) of the NAIC in order to record standardized values for all companies, for use in financial statements submitted to each state. In this way, a particular bond issue held by several companies is carried at the identical statement value in each of their annual statements. This procedure is particularly necessary for private placement bonds, for which current market price quotations are not available. The role of the SVO is to review each security as to its credit standing, to determine whether it may be carried at amortized value or marked down to a lower statement value because of actual or imminent default. For public bond issues for which independent credit ratings are available, the SVO can determine whether amortized values can be used in company statements; current market quotations are available for most common stocks.

This procedure for determining credit ratings and values for securities held by life companies is necessary not only for providing standardized values for statement purposes, but also to determine required contributions to the MSVR. As described earlier, bonds in the lower quality grades are required to contribute larger amounts to the MSVR than bonds in the higher grades, and the SVO classifications provide the necessary gradings for company use on a uniform basis.

h. Solvency Monitoring

In the interests of protecting consumers who purchase life insurance and annuities, the regulators recognize that financial soundness of individual companies must be maintained, to assure their capability to pay benefits and claims to the public. Perhaps the first line of defense of company solvency lies in

the state laws and regulations dealing with capital and surplus requirements, liabilities and reserves, and limits on permitted investments--all of which are designed to maintain a safe and sound financial condition among companies.

A second line of defense is the regulatory procedures for reviewing financial statements filed with each state and the financial examination of the company's accounts. As a general practice, each company is examined by the state regulators every third year, unless there are indications of difficulties which warrant more frequent attention. Priority is assigned to problem companies, based on review of financial statements, history of deteriorating financial condition, change of management control, or information from outside sources that difficulties have arisen. While many states reserve the right to examine any insurance company licensed in their state, financial examinations are usually conducted only by the state of domicile.

A key element in solvency surveillance and identification of troubled companies is provided by the Central Office of the NAIC, which developed an Insurance Regulatory Information Service (IRIS) several years ago to monitor potential insolvency situations. Annual statements filed with the NAIC are used to compile 12 financial ratios thought to indicate impending financial difficulties (see Appendix). If a company has four or more ratios outside the usual range, further analysis is undertaken in greater depth and regulators in the state of domicile are notified of the need for further review. The system has been useful in identifying a number of troubled companies in recent years, but there have been doubts within the industry as to whether they have the same predictive value for large companies that they seem to have for smaller insurers. Further refinements in the ratios and the review process are now in process by the NAIC. Since financial examinations by state regulators normally are conducted on a triennial basis, the IRIS system allows for more timely means to correct troubled situations among life companies.

When an insurer is found to be in serious financial difficulties, or is actually insolvent, the state insurance department is required to assume control over the company's assets and management. A court order is obtained to appoint the regulator as receiver for the purpose of rehabilitating the company, if that can be accomplished, or liquidating the company if it is insolvent. The NAIC has developed model laws for such procedures and these have been adopted by most states. In the distribution of assets provided by these laws, highest priority is given to costs of administration, employee salaries, and policyholder claims.

Insolvencies among U.S. life insurance companies have been on the rise over the past few years. Before 1987, insolvencies numbered 10 or less and involved smaller companies with assets below $50 million. In 1989 there were 40 insolvencies, including an insurer with $646 million in assets. A task force of the ACLI that undertook a special study of the insolvencies during the 1985-1990 period focused on 68 cases, finding the causes to include affiliate transactions (often involving fraud) in 47 cases, problems in accident and health insurance lines in 41 cases, underpricing of products in 40 cases, investment problems (often real estate) in 31 cases, and problems with new management in 25 cases. The identified causes were, of course, often interrelated.

A series of insolvencies of major life insurance companies surfaced in 1991, leading to wide scale public attention and calls for reform in regulatory standards. The first of these insolvencies was Executive Life of California (a $13 billion company) followed by its affiliate, Executive Life of New York (a $3 billion company). Soon after, a $4 billion company in California named First Capital Life was taken over by the state insurance department, as was its $4 billion affiliate called Fidelity Bankers Life in Virginia; both units were shut down to halt the surge in policyholder withdrawals of policy funds.

A similar run on policy funds also brought on the takeover of Mutual Benefit Life in New Jersey (a $13 billion company) in July 1991, when solvency was threatened mainly by the withdrawal of pension money. A $4 billion company, Monarch Life in Massachusetts, was taken over by the state commissioner when its parent company had problems that threatened its solvency status.

The insolvencies of 1991, involving much larger companies, were directly related to investment problems arising from (a) over-investment in high-risk "junk bonds" which have fallen sharply in price, and (b) defaults on commercial real estate mortgage loans, leading to sizeable book losses. Regulators took charge of the affected companies in large part to halt mounting withdrawals of policyholder funds which developed after the deterioration of these companies' asset base became widely known.

i. State Insurance Guaranty Funds

State guaranty associations have been established in every state (but not the District of Columbia) to satisfy benefit claims of policyholders and annuitants, in the event that an insurance company liquidated through insolvency does not possess sufficient assets. The deficiency is met by assessments on all companies licensed in the state of the liquidated insurer. While provisions of these guaranty funds are not uniform, typical coverage is $300,000 in death benefits, $100,000 in cash or withdrawal value for life insurance, and $100,000 in present value of annuity benefits. Some states also provide varying coverage for unallocated annuity contracts purchased by employers to fund pension plans, usually limited to $5 million for any one contract holder.

Most guaranty funds limit protection to residents of their own state, regardless of where the insolvent insurer is domiciled. Other states cover all policyholders of an insolvent domiciled company, regardless of the residence of claimants. Assessments on the companies is made after the fact, rather than through pre-funding, as is the case in federal deposit insurance for banking and thrift institutions. Based on the amount of direct premiums received in the state during the previous year, assessments are limited to 2 percent of such premiums in a given year. Such assessments may be offset against the payment of state premium taxes that are levied annually on insurers; thus, the major burden of such assessments falls on state revenues and hence on taxpayers in the states.

j. Role of the National Association of Insurance Commissioners in Insurance Regulation

Passing reference frequently has been made to the NAIC and its involvement in a wide range of regulatory matters. This body was created by insurance commissioners of the several states in 1871 as a common ground for finding solutions to mutual problems. The objectives of this body are to promote uniformity in insurance laws and regulations among the states, by developing "model laws"; to improve the quality and effectiveness of insurance departments in their administration of laws and regulations; and to protect the interests of the insurance public.

A Central Office has been established by the NAIC with a sizeable full-time staff, in addition to the Securities Valuation Office which reviews the quality standing of bonds and stocks carried in the annual reports of life companies. Meetings of all commissioners are held twice yearly, plus interim meetings of the many standing committees charged with developing model regulations and laws as well as other policy guidelines. Financing of these activities is primarily from user fees charged to life companies, rather than from contributions from state insurance departments.

Over the years, the NAIC has developed more than 100 model laws and regulations dealing with almost every aspect of insurance operations. Such models are not binding on the states, but they have been widely accepted and have brought about a large measure of uniformity among states in the regulation of life companies. In addition, the NAIC activities have precluded much duplication of effort among the states and among the regulated life companies; use of a uniform format for annual statements is but one example.

Because of its continuing influence and growing prestige, the NAIC has become the principal rule-making body for insurance regulation within the United States. Model laws are developed only after lengthy hearings involving both regulatory and industry viewpoints along with technical input from departmental staff. With some modifications, such models have been widely adopted by state legislatures within two or three years of promulgation by the NAIC. In brief, the NAIC has provided a forum for orderly and reasoned consideration of the evolving standards of insurance regulation affecting the vast majority of life insurance companies.

At the same time, it should be noted, there have been repeated efforts on the part of federal legislators to develop a federal government presence in the regulation of insurance, by preempting the role of the states or by imposing minimum federal standards of insurance regulation which the several states would be required to follow. One approach has been to provide optional federal chartering of insurance companies, allowing individual companies to choose between state and federal regulation. Other approaches would take over certain aspects of company regulation, leaving other matters to the states. Such proposals have been prompted in recent months by the rash of insurer insolvencies which have occurred under the state regulatory system.

k. Consumer Protection

Although reference to protection of consumer interests has been made at several points above, a brief recapitulation of such measures may be in order. The insurance buying public is first protected by regulators which review policy contracts to see that they are understandable, fair to the buyer, and consistent with policyholder rights set forth in the law. Agents must be licensed by the state, and their commissions are governed in large part by state laws. Regulations also define certain elements of the sales illustrations they use to show the costs of the policy, and the states often publish buyers' guides to allow consumers to compare insurance costs among companies. Insurance departments periodically review the market conduct of companies in their states, to be sure that agents are treating policyholders fairly and in conformance with the laws. A few states provide a service to prospective buyers of divulging the number and nature of consumer complaints they have received about a given company. However, the use of an "ombudsman" to help resolve conflicts between policyholders and companies has not yet developed in the United States.

The other element of consumer protection relates to regulation of the insurance companies, with emphasis on their financial condition. Use of standard mortality tables, requirements for adequate reserves, restraints on investment practices, valuation and nonforfeiture laws, review of policy forms, submission of financial statements, periodic financial examinations and a myriad of related measures are all designed to maintain the solvency and claims-paying ability of the insurer. Where such measures have failed, and insolvency occurs, state guaranty funds have been established to satisfy policy claims if assets are insufficient.

Beyond these safeguards, the policyholder may have recourse to the courts for the redress of any grievances relating to insurance. Such matters fall under general laws since judicial review is outside the province of state insurance departments.

VI. OPERATIONS AND PROFITABILITY

a. Operating Expense Ratios

In describing the operating systems, expenses and financial results of the companies that constitute the life insurance industry in the United States, it must be recognized that there are wide variations among individual firms--large and small, stock and mutual, old and new firms. Nevertheless, rough guidelines to operating ratios of various kinds are provided by annual tabulations of industry operating data.

All-industry data tabulated by the ACLI for the year 1989 show insurance company income dollars as arising 69.7 percent from premiums and annuity considerations, while the remaining 30.3 percent was from net investment earnings and other income. On the outgo side, benefit payments were 53.1 percent, additions to policy reserve funds were 30 percent, and additions to special reserves and surplus funds were 1.7 percent of the insurance dollar. Operating expenses were divided into commissions to agents for 4.7 percent of the total, with another 7 percent going to home office and field office expenses. Finally, taxes were 2 percent of the insurance dollar, while dividends to shareholders of stock companies were 1.5 percent of the industry total. (For stock companies alone, shareholder dividends were 2.4 percent of their insurance dollars.)

As noted, these shares vary widely by line of business; thus, investment earnings accounted for 29.4 cents of each life insurance dollar but were 47.6 percent of each annuity income dollar, according to a special study by ACLI for the year 1983. On the outgo side, the life insurance line added 20.6 percent of its dollar income to reserves, while the annuity line set aside 63.3 percent for reserves in 1983.

Operating expenses, which made up 11.7 percent of company outgo in 1989, are further broken down in another ACLI tabulation which shows commissions as 41.5 percent of the expense total, with 22.6 percent going to salaries and wages and 4.3 percent for contributions to employee benefit plans. Advertising expenses were 1.4 percent, real estate costs made up 4.4 percent and all other operating expenses accounted for 25.8 percent of the total. Investment operations required 11 percent of total operating expenses, while insurance operations accounted for the remaining 89 percent.

All of the foregoing expense shares have remained fairly stable in recent years. However, there were wide differences between the expense ratios reported by stock and mutual companies, evidently because of differing methods of conducting business and the lines of business in which they were engaged. For example, mutual companies paid 29 percent of their operating expenses in salaries and wages, while stock companies paid 19 percent. Conversely, mutual companies paid a lower share of total expenses in commissions at 26 percent, compared with 51 percent paid by stock companies out of their expense dollars. Also, investment operations accounted for 19 percent of the expense dollars of mutual companies, while stock companies paid a much lower 6 percent of total expenses on investments.

b. Profitability Measures

Because of the unique accounting system used by life insurance companies, profitability of the industry has always been difficult to measure or to compare with other financial institutions or corporations. For insurers, profitability is affected by a host of factors including actual mortality experience, investment earnings, capital gains or losses, the scale of policyholder dividends, and federal and state taxes.

One crude measure that may be used to measure trends in profitability is the ratio of capital and surplus to total assets; if this ratio declines over time, profitability must be on the decline and vice-versa. From 8.4 percent in 1970, the capital-asset ratio for the industry slid to 7.2 percent in 1980 and declined further to 6.4 percent in 1990. But this ratio does not tell the full story, since it fails to include the MSVR--the special reserve standing behind both bonds and stocks, adding 20 percent or more to the size of the capital base. Under the MSVR system, capital gains from the common stock portfolio are channeled first into the MSVR and then into the surplus account only after reaching a prescribed maximum; losses are charged against this reserve in order to cushion surplus against market price fluctuations. Gains and losses on bondholdings are also channeled into the MSVR according to formulae set up under NAIC rules. Adding the MSVR to capital and surplus, the total capital ratio for the industry has been virtually unchanged for the past decade, standing at 8 percent of assets in 1989, followed by a slight decline to 7.6 percent in 1990.

It must be noted, however, that capital-asset ratios deviate widely around this industry average. According to a special study by an ACLI task force on solvency problems, large insurance companies with assets over $5 billion showed average capital-asset ratios of 5.3 percent, in sharp contrast to small companies with assets under $100 million where average ratios were 20 percent. Yet, the larger companies are often viewed as the stronger, financially sound companies while smaller companies have had a much worse record for insolvencies in recent years. Evidently, capital ratios are only one of many indicators of financial strength and profitability trends.

While there are no widely accepted measures of profits in the life insurance field, certain crude approximations are possible, using industry data compiled from annual statements. The base for such measures is capital and surplus, plus the security reserves of the MSVR at the beginning of each year. Industry earnings may then be defined as "net gains from operations" from which dividends to policyholders must be subtracted since they are a normal part of insurance practice. However, capital gains or losses on investment funds should also be factored in, since they reflect financial results of the companies in a given year.

If the definition of industry earnings is taken to include only realized capital gains (or losses), the profit ratios work out as shown in column A. If unrealized capital gains (or losses) are included in industry earnings, the results appear in column B, as follows:

	Column A	Column B
1985	25.1%	36.0%
1986	32.1	27.8
1987	16.3	2.0
1988	15.8	20.2
1989	22.4	31.7
1990	16.5	4.1

These rough calculations illustrate the variability of industry earnings, regardless of the method used, and call into question the usefulness of such measures as a benchmark for comparisons. Using data that include only realized capital gains and losses is probably the better of the two measures, but substantial unrealized losses cannot be totally ignored since they carry implications for later operating results.

Another complication in measuring profits is the fact that company holdings of bonds and mortgages are not "marked to market", i.e., they are carried close to acquisition cost unless they go into default. If market interest rates rise sharply in a given year, the market value of fixed-rate bond holdings obviously goes down, but this is not normally reflected in statement values or recorded as an unrealized capital loss for the year. Conversely, declines in market interest rates would raise the liquidation value of bondholdings, but this is not recorded as a capital gain. In short, the use of stabilized values for bonds and mortgages which make up the bulk of industry assets makes it difficult to know the true state of company assets, surplus, or profits in a given year. The rationale for maintaining stabilized asset values is that an industry with long-term financial liabilities and assets should not be subject to the vagaries of short-term or interim fluctuations in market prices (except for its holdings of common stock which are carried at market values).

c. **Taxation**

Federal income taxes levied on life insurance companies are based on a separate statute designed to take account of the special features of the business, differing from the normal taxes on corporate profits. Over the years, there have been a number of revisions in life insurance tax methods, embodying a variety of complex approaches. The present law, enacted in 1984, is fairly similar to standard corporate income taxation of net income after expenses, but with two major exceptions. The first is a deduction for dividends paid to policyholders, viewing such payments as a normal and necessary part of insurance practices which adjust the net premiums paid for insurance coverage. The second exception is a special 20 percent deduction from gross income (net gains from operations) in order to keep life insurance companies competitive with other financial institutions. In 1990, a further revision in the federal tax law for life insurance raised the tax burden by substantial amounts, by disallowing the previous deduction for "deferred acquisition costs", primarily consisting of company commitments to pay commissions on policy renewals in later years. Such costs previously had been carried as a current expense and a current tax deduction.

At the state level, life insurers are required to pay a flat-rate tax, normally 2 percent, on the gross premiums received from residents within the state. Premium taxes are levied on out-of-state companies to the extent that they collect premiums from residents of the state. To prevent state legislatures from charging higher premium taxes on out-of-state companies, in order to favor their domestic companies, a defensive form of reciprocal tax rates has developed. Under this system, if State A charges higher premium taxes on a company domiciled in State B, the law in State B provides that companies based in State A will likewise be charged a higher tax on the premiums collected from State B. This form of reciprocity has kept state premium taxes fairly uniform at the 2 percent level.

Beyond these two forms of taxes, life insurers pay normal business taxes for social security for its employees, property taxes on real estate it owns and uses for company purposes, sales taxes on furniture and supplies it purchases, and state income taxes levied in several states on business profits.

VII. PUBLIC POLICY ISSUES

A number of persistent policy issues of public concern have received repeated consideration, both inside and outside the life insurance industry, during the past several years. This section will describe these issues in terms of the pros and cons that have been raised, but without taking sides or attempting to resolve these controversies. It is believed, however, that each of these issues deserves the close attention of policymakers concerned with the equitable and proper conduct of insurance operations.

a. Taxation of the Inside Buildup

A recurring policy question raised by tax specialists has been the exemption from tax of the interest earnings on accumulated assets arising from cash-value life insurance, i.e., the "inside buildup" on whole life products. Such earnings are currently untaxed under federal income tax laws, as explained in Section III-b above.

The primary argument for taxing the inside buildup rests on the premise that cash- value life insurance has a savings element which should be treated the same as any other form of personal saving. Interest earned on corporate bonds, money market funds, bank certificates of deposits and the like is subject to current income taxation; hence, it is argued, life insurance should be taxed the same as a matter of tax equity. Of equal importance to proponents of such taxation is the fact that taxing the inside buildup would add many billions of dollars in needed federal tax revenues each year. The U.S. Treasury department proposed such taxation as part of general tax reform measures in the early 1970s and again in the mid- 1980s, but the proposals were not adopted by the U.S. Congress on either occasion.

Life insurers protested that the inside buildup was a necessary and integral part of providing permanent insurance protection, arising from the level-premium method of payment for whole-life insurance. The industry argued that it would be unfair and unworkable to levy taxes on a form of asset increase which had not yet been "constructively received" by the policyholder; it would be like taxing the increase in the value of a family's home each year, even before the home was sold. Moreover, such taxation would fall most heavily on older taxpayers whose policies had built up a sizeable cash value through the years, with sizeable interest credits occurring in later years. The companies posed the problem that older people might cash in their policies to avoid a new tax, leaving them without coverage when it was most needed. It was further urged that future sales of level-premium cash-value life insurance would fall off drastically if this new tax were adopted, leaving large numbers of widows and children with little or no coverage and possibly dependent on public support in the absence of private resources. In any case, it was argued that life insurance policies are basically different from market-place investments such as bonds and stocks and should not be taxed in the same way.

b. Life Insurer Solvency

Because of the rising tide of company insolvencies, including a number of larger firms in recent months, the issue of solvency has taken on new prominence for the public, the regulators, state and federal legislators, and the industry itself. The basic concern of all parties is to preserve the ability of insurers to meet the claims of their policyholders.

In order to protect the consumer public, the most fundamental mission of insurance regulators is to maintain the solvency of the companies within their jurisdiction. This function is carried out through a variety of statutory requirements and supervisory activities, including restrictive investment laws,

review of company policy forms and marketing techniques, analysis of periodic financial statements, examination of company books, etc. as described in preceding sections of this paper. In retrospect, flaws in this regulatory system have been exposed in the past few years, evidenced by the number and size of insurance companies that have required regulatory intervention.

For policyholders, the solvency issue revolves around the question of full and timely payment of claims for death benefits, annuities, and pensions on which they have relied. For the industry at large, public alarm that insurance insolvencies might spread could persuade policyholders to withdraw their funds from otherwise sound companies, forcing liquidation of assets at a loss, endangering their capital base, and bringing on insolvency that was not otherwise in prospect. For regulators, the insolvency issue suggests that they have not adequately performed their basic supervisory function and that they need tighter standards or broader powers, For all parties, there appears to be general agreement that reforms are needed.

Working through the NAIC, state insurance regulators have developed a solvency agenda of actions designed to tighten their policing of companies, including minimum standards for insurance department resources, improved evaluation of reinsurance practices, more effective examinations of companies, bigger budgets for solvency analysis by NAIC, and development of risk-based capital requirements. In addition, the regulators are working toward special reserves against mortgage loans, similar to the mandatory reserve for securities. Broadly stated, state regulators have been bending every effort toward strengthening their supervisory resources and powers, in order to head off further insolvencies which will discredit their performance as regulators.

Within the life insurance industry, acting through the ACLI, a special Task Force on Solvency Concerns was established in September 1989 to analyze the causes for the upsurge in insolvencies and recommend policy changes to the ACLI Board. One year later, after careful study of solvency issues, the Task Force recommended a series of steps designed to tighten state regulation in the investment area, to improve solvency oversight methods, and to strengthen the funding of insurance department operations. Subsequent policy positions of the ACLI have supported specific means to carry forward these broad recommendations.

The U.S. Congress has been alert to the financial problems of the life insurance industry, cognizant of the recent widespread failures among savings and loan associations and in the commercial banking field. Proposals have been made for a new federal role in the regulation of life insurers, providing for such solutions as federal minimum standards for state regulators to follow, with the threat of federal takeover of regulation if states fail to comply (see below).

As noted earlier, the rash of insolvencies among smaller companies has been traced to a variety of causes, ranging from fraud and mismanagement, to underpricing of products, to poor investment performance. The highly publicized insolvencies in 1991, however, appear to stem directly from investment problems, particularly with excess concentration on high-yield, low-grade corporate bonds which have fallen sharply in market price. A wider range of large companies have become suspect because of heavy holdings of mortgage loans on commercial real estate which have become delinquent or gone into foreclose because of overbuilding and high vacancy rates. In the last analysis, however, the ultimate responsibility for insolvencies in the life insurance industry appears to rest with inadequate supervision by the state regulatory authorities, and a great many steps are now being taken to correct this situation.

c. **State versus Federal Regulation**

As previously noted, regulatory authority over the insurance industry was reserved to the states in 1945 with the passage of Public Law 15, known as the McCarran- Ferguson Act. Since that time, however, they have been many proposals to impose federal regulation to supplement or supplant state supervision of insurance, either because state regulation is too cumbersome or deficient in protecting the public interest.

Those who favor federal regulation argue that continuing lack of uniformity among the insurance laws of 51 separate jurisdictions results in unnecessary and unwelcome complexities in company operations. Filing annual statements in each of the states in which it operates is both costly and inefficient for a company operating over wide areas or nationwide. Also, when a company designs a new insurance product it must submit such policy forms for approval by each of the several states in which it plans to offer the product, requiring much duplicative expense and delay.

Since most insurance commissioners are political appointees, they are sometimes viewed as unqualified to oversee the complex business of insurance. Moreover, many of the state insurance departments are felt to be understaffed because of budget constraints and therefore unable to regulate properly. Critics outside the industry have charged that state regulators are subject to undue influence on the part of local insurance companies; they argue that an arms-length relation with a federal regulator would be more even-handed and therefore preferable. While most life companies oppose federal regulation of insurance, a number of the larger life companies operating on a national scale favor federal regulation as a more efficient and logical form of both chartering and supervision of company operations. In the early 1970s, a number of life companies actively supported new Congressional legislation providing for optional federal chartering of life companies, but the proposal was not widely favored within the industry and it failed of passage.

The arguments favoring state regulation start with the concern that a single regulatory body at the federal level might prove to be unsympathetic to local conditions, slow to respond to changes, inflexible in rulemaking, and high-handed in its decisions. On the positive side, it is argued that the NAIC has brought a high degree of uniformity among state insurance codes through a long series of Model Acts adopted over the years. Local problems can be handled on the local level with state regulators. An unwise state insurance law or regulation may have a local impact but a nationwide effect is avoided. Those who defend state regulation may admit to its defects, but they argue that the remedy is to strengthen and support the present system rather than to turn to an unknown and untested system of federal regulation.

A new phase in the controversy over federal vs. state regulation opened in mid-1991 after the much-publicized insolvencies of several large companies. Congressional proposals were made to set up a federal insurance authority which would establish detailed regulatory standards for insurance operations. If a state regulatory authority satisfied the minimum federal standards it would be accredited to supervise companies in its jurisdiction; if the federal regulatory standards were not met, companies domiciled in that jurisdiction would lose their license to conduct interstate business unless and until they were re-domiciled in an accredited state. The federal authority would also have power to bypass the state regulator and suspend the license of an individual company directly, whenever necessary to protect the public. The future of such proposals is uncertain.

d. Guarantee Funds and Moral Hazard Issues

The state guarantee associations which have been established in all but one jurisdiction since the early 1970s are designed to assure payment of policyholder claims, up to specified dollar limits, in the event of impairment of surplus or insolvency of an insurance company. One concern that slowed the passage of such enabling legislation was the question of moral hazard, that is, the fear that the presence of such guarantees would open the door to unsafe practices or unfair pricing by rival firms, leaving others to make good on insurance claims if insolvency resulted.

In practice, the backup of guarantee funds for life insurance policies is roughly similar to federal deposit insurance for banks and savings and loan associations. In order to bring in new business by offering higher interest rates on investment-oriented products, companies may be implicitly encouraged to assume higher investment risks if there is a guarantee fund present to "pick up the pieces" in the event of later collapse through insolvency. Thus, the presence of a guarantee fund may tend to bring on the situation it is intended to correct, some analysts assert. Of course, much the same may be said of federal deposit insurance, established in the 1930s to enhance public confidence in commercial banks and savings and loan associations. In fact, many observers today contend that a contributing factor in recent widespread failures of savings and loans has been the willingness of depositors to place money with shaky institutions to obtain higher savings rates, confident that federal deposit insurance would cover any shortcomings in the institution's investment performance.

While the moral hazard issue is difficult to deny, the larger advantages of state guarantee funds, as with federal deposit insurance, have convinced most affected parties of their necessity. In the life insurance industry, financially sound companies can be exposed to policyholder withdrawals of considerable magnitude, if there is a loss of public confidence arising from insolvencies of other life companies, or even a more general concern about the financial stability of the industry. It is for this reason that companies have been willing to support guarantee fund arrangements, and to pay the assessments that they may require, as a necessary price for maintaining the good name of life insurance in the public mind.

e. Investment Regulation and Safety

An inevitable conflict between risks and returns is ever present in investment practices of the insurance industry. On behalf of the consumer public, state regulators insist on a high degree of safety of invested funds, expressed largely through requirements for diversification of assets and for minimum standards of asset quality. By contrast, investment departments of life companies are inclined toward maximizing investment returns, within the bounds of reasonable safety of principal, in order to produce investment yields that will attract customers to their products and/or increase company profitability. The problem is to arrive at an appropriate balance between these conflicting objectives.

Over the years, investment restrictions imposed by state regulators have been very conservative, often based on a list of permitted investment forms along with specific quality standards and backed by limits on asset percentages allowed in the various investment categories. To provide for a degree of flexibility, the state laws in the late 1950s adopted "leeway clauses" by which companies could invest up to 2 percent of assets in forms not otherwise specified. Later, the leeway clauses were liberalized in stages to allow as much as 10 percent in any form the company desired. Such leeway was used not only for innovative investment instruments, but also to cover that portion of mortgage loans that exceeded the limit of 75 percent loan-to-value ratios and to stretch other investment standards in similar ways.

A radical change in investment regulation in New York State occurred in 1983, with the abandonment of qualitative restrictions on investments, i.e., those dealing with credit standards and quality requirements. These were replaced with a looser "prudent individual" rule along the lines that had prevailed for many years in the State of Wisconsin with good results. However, interpretations of what investments are "prudent" in the business sense can be the source of much disagreement, particularly when state regulators are expected to monitor and enforce investment laws in their periodic examinations.

In view of the recent insolvencies of companies that invested heavily in high-risk "junk bonds", there have been serious concerns about the failure of regulators and the companies alike to observe proper safety standards in their investment operations. In reaching for high yields to fund the popular investment-oriented products, life insurance companies have also invested heavily in commercial real estate mortgages which have since encountered record delinquencies because of the overbuilding of office space in 1989-90, followed by the economic recession of 1990-91 which produced high vacancy rates nationwide. The problems with commercial real estate have been shared by other institutional lenders, however, particularly the commercial banks and savings and loans. In view of the general economic conditions which have led to the recent poor performance of commercial mortgages, it is not clear that such loans were inherently "unsafe" or that state regulators should share the blame for the recent difficulties resulting for life companies. Still, it is likely that a more watchful attitude among the regulators will prevail in future years.

f. <u>Accounting Standards for Asset Valuation</u>

Life insurance companies are required to carry common stocks at market value in their annual statements. Bonds that have gone into default must also be carried at market, and those securities that appear to approaching default are marked down from their previous statement values. However, those bonds and mortgages that are meeting their interest and principal repayments on schedule are considered "in good standing" and are carried in financial statements at "amortized value", i.e., at or near their original purchase price.

The implications of this system of asset valuation becomes clearer when it realized that a rise in market interest rates on corporate and government bonds means a corollary decline in the market price of outstanding issues. But such declines are not registered in the financial statements of life insurance companies if the bonds are in good standing. Such treatment differs radically from such investments as mutual bond funds which are "marked to market" monthly if not daily.

The rationale behind using stabilized values for life company bond portfolios stems primarily from the traditional practice of holding bonds to maturity, rather than trading bonds frequently at short intervals. If a bond is not to be sold before it matures, why should the interim fluctuations in market yields and prices be allowed to change the statement value on the company's books, it is argued. More broadly, if the life insurance company is viewed as an ongoing concern with a long time horizon, there is no reason to record its assets at liquidation values as if it is expected to go out of business tomorrow.

Another practical reason for stabilized values is the fact that a large share of life company bond portfolios consist of single-owner private placements in large denominations for which no ready market value exists; current resale price can be only roughly estimated. Similarly, commercial mortgage loans do not carry a market price that can be recorded with accuracy; thus, original value is normally used for statement value.

To underpin this system of stabilized values for most bonds, state regulators in the 1940s established the Mandatory Securities Valuation Reserve (described earlier). In the event that a bond is sold at a loss before maturity, or goes into default with a consequent mark-down in value, such losses are charged against the MSVR. In this way, company surplus is not affected until the Reserve is exhausted. As explained earlier, bonds with a lower credit rating must contribute more heavily to the MSVR each year than the higher-grade bonds that are in good standing.

There is no special reserve against mortgage loans in life company portfolios at present. In past years, mortgage loans have not produced notable losses; those losses that did occur were charged against surplus. More recently, after mounting defaults on commercial mortgages, there have been proposals for expanding the reserve system to provide for mortgage losses as well as bonds and stocks.

Over the years, there have been frequent criticisms of the current system of stabilized values, both from the accounting profession and from state regulators themselves. The argument for current market values on all investment assets is based on the concept of "full disclosure" and the public's right to know the true condition of the institution, so that they can evaluate the safety of the funds they have entrusted to it. But a counter argument is made that the public should not be given a false cause for alarm by recording declines in market values that have not translated into realized losses; such false alarms could produce destabilizing withdrawals without due cause, to the detriment of both companies and policyholders.

The most persuasive argument against marking all assets to market, however, is the logical corollary of marking all liabilities to market. In simple terms, if interest rates rise and overall asset values decline in market terms by, say, 10 percent, should the policyholder be informed that the dollar value of his insurance coverage has likewise been reduced that year by some percentage? Few insurance regulators would be willing to accept a system with that form of disruptive and misleading information.

g. Linkages between Banks and Insurance Companies

In the main, linkages between commercial banks and insurance companies are prohibited in the United States. There are, however, exceptions to this basic rule. National banks are permitted to sell and underwrite credit life insurance, related to consumer loans and mortgage loans. They also may sell insurance in towns with a population of 5,000 or less or in any location deemed to have inadequate insurance agency facilities. State-chartered banks in 13 states may sell (but may not underwrite) insurance unless they are part of a bank holding company system, for which federal law prohibits such activities. As a result of these restrictions, actual sales of life insurance by commercial banks has been minimal, limited mainly to bank sales of credit insurance.

During the past 10 years, a number of federal and state legislative proposals have been offered, with the intent of breaking down the long-standing barriers between banking and insurance. At the state level, permissive legislation has been enacted in two states (South Dakota and Delaware) but adverse rulings by the Federal Reserve have prevented actual sales activities. In addition, a number of court cases have arisen over legal interpretations of state and federal laws, but with no basic changes resulting in the fundamental rules. At the federal level, no new legislation has been enacted in the banking-insurance area although new proposals are currently pending in the U.S. Congress.

The legal separation of banking and insurance powers dates back primarily to the Banking Act of 1933, known as the Glass-Steagall Act, which limited bank activities in insurance and also separated

commercial banking and corporate securities underwriting. The reasons for separating banking and insurance, and the arguments for retaining the barriers to such linkage include the following:

1. Permitting banks to conduct insurance operations, or insurance companies to conduct a banking business, could produce an unhealthy concentration of economic power either nationally or at the local level. Combining financial powers under a single ownership could reduce competition in loan markets, particularly in localized markets for home mortgages, farm mortgages or business loans.

2. Commercial banks would gain an unfair competitive advantage over insurance company agents, since they could draw upon inside information regarding a depositor's financial status in drawing up prospect lists for insurance sales. Also, businesses and consumers seeking bank loans could be subject to subtle pressures to buy their insurance from the bank, in order to gain approval of their loan application.

3. Since bank deposits are federally insured, and the public feels that their funds are safe, they may also favor purchase of insurance from a commercial bank in the belief that the federal backing also applies. Insurance companies would thus be left at a disadvantage because of this likely confusion in the public mind.

4. Banks should not be allowed to engage in non-banking activities such as insurance or securities underwriting, since they could expose the bank to financial risks that could jeopardize the safety and soundness of the banking system on which the public relies.

On the other side of the argument, those who favored bank entry into the insurance field offered the following views:

1. Competition would be enhanced, and the public better served, if banks were allowed to offer insurance products to the public. Some supporters suggested that the cost of insurance would be lowered by such bank activities because of cost-saving efficiencies.

2. Commercial banks have been losing market share in the financial markets, not only in domestic markets, but also in relation to foreign banking enterprises such as the Japanese. Permission to enter the insurance and securities businesses would enlarge the financial size and scope of commercial banks in the United States, and allow them to compete more effectively on a global basis.

3. Entry into insurance and security sales would enhance bank profits and thereby improve the financial soundness and capital base of commercial banking.

4. These enlarged powers for commercial banks would improve their diversification and thereby enhance the financial stability of the commercial banking system.

5. Allowing financial institutions to conduct financial business of all kinds, without the present compartmentalization, would serve the public's need for "one-stop financial services" and provide a "level playing field" among financial institutions on a fair and equal basis.

While the majority of life insurance companies are opposed to bank entry into the insurance field, a few companies have supported such a change on the condition that life insurance companies would be allowed to own commercial banks. The reasons behind their position include the following:

1. Life companies that owned a commercial bank would be able to offer a wide range of banking services to their policyholders, both individual and corporate. These include federally insured bank accounts and certificates of deposits, plus bank credit cards, plus various trust services to complement the present lines of insurance.

2. There are a number of operating synergies between banks and insurance companies, including maintenance of customer records, extending related services to established customers, expertise in financial markets and lending procedures, etc. Combining banking and insurance operations could bring in new customers and better profits if conducted efficiently.

3. More generally, some life insurance companies in the 1980s came to believe that the financial services revolution of that period would lead in time to the wholesale removal of legal barriers to affiliations of banks, insurance companies and securities firms. Accordingly, they sought to be in the fore-front of such simultaneous activities in order to gain an early foothold, capture market share and thereby strengthen their own profit potential.

As a practical matter, legal barriers to the full-scale integration of banking, insurance and securities firms have not been repealed to date. Moreover, the appeal of reciprocal entry into such financial operations has been sharply reduced by the widespread failure of banks, the financial problems of investment bankers and securities brokers, and the recent insolvencies among life insurance companies. Prospects of greater profits through financial integration have faded, the pressures for repeal of existing barriers to reciprocal entry have diminished, and the corporate planning for entry into related financial fields no longer carries a high priority.

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APPENDICES

Appendix A: Performance Ratios Used by the Insurance Regulatory Information System (iris) of the NAIC to Review Solvency.

Appendix B: Profitability Ratios of Life Insurance Industry Aggregates, 1985-1990.

APPENDIX A

PERFORMANCE RATIOS OF IRIS

RATIO 1	CAPITAL AND SURPLUS CURRENT YEAR - CAPITAL CHANGES PAID IN - SURPLUS ADJUSTMENTS PAID IN - CAPITAL AND SURPLUS PRIOR YEAR DIVIDED BY CAPITAL AND SURPLUS PRIOR YEAR
RATIO 2	NET GAIN FROM OPERATIONS DIVIDED BY TOTAL INCOME
RATIO 3	COMMISSION ON PREMIUMS AND ANNUITY CONSIDERATIONS + GENERAL INSURANCE EXPENSE DIVIDED BY FIRST YEAR PREMIUMS COLLECTED + SINGLE PREMIUMS COLLECTED + RENEWAL PREMIUMS COLLECTED + ANNUITY AND OTHER FUNDS DEPOSITS
RATIO 4	NET INVESTMENT INCOME DIVIDED BY TABULAR INTEREST INVOLVING LIFE OR DISABILITY CONTINGENCIES + TABULAR INTEREST ON ACCIDENT AND HEALTH POLICY FUNDS + TOTAL INTEREST CREDITED ON DEPOSIT FUNDS AND OTHER LIABILITIES WITHOUT LIFE OR DISABILITY CONTINGENCIES
RATIO 5	NON-ADMITTED ASSETS DIVIDED BY ADMITTED ASSETS
RATIO 6	REAL ESTATE (ASSETS) DIVIDED BY CAPITAL AND SURPLUS
RATIO 7	INVESTMENTS IN AFFILIATES DIVIDED BY CAPITAL AND SURPLUS
RATIO 8	COMMISSIONS AND EXPENSE ALLOWANCES ON REINSURANCE CEDED - COMMISSIONS AND EXPENSE ALLOWANCES ON REINSURANCE ASSUMED DIVIDED BY CAPITAL AND SURPLUS
RATIO 9	TOTAL PREMIUMS CURRENT YEAR - TOTAL PREMIUMS PRIOR YEAR DIVIDED BY TOTAL PREMIUMS PRIOR YEAR
RATIO 10	CHANGE IN PRODUCT MIX
RATIO 11	CHANGE IN ASSET MIX
RATIO 12	CHANGE IN RESERVING RATIO

APP ˙NDIX B

LIFE INSURANCE PROFITABILITY
(in billions of U.S. dollars)

	1985	1986	1987	1988	1989	1990
Prior year data:						
Capital and surplus	$50	$57	$64	$67	$75	$84
MSVR	10	11	15	16	18	19
Total C,S, MSVR	60	68	79	83	93	104
Current year results:						
Net gains from operations[1/]	10.4	8.8	6.3	10.1	14.2	17.3
Plus: realized capital gains	4.7	13.0	6.6	3.0	6.7	-0.1
Total	15.1	21.8	12.9	13.1	20.9	17.2
As percent of C,S, MSVR	25.1%	32.1%	16.3%	15.8%	22.4%	16.5%
Net gains from operations[1/]	10.4	8.8	6.3	10.1	14.2	17.3
Plus: Total (net) capital gains	11.2	10.1	-4.3	6.7	15.3	-13.0
Total	21.6	18.9	2.0	16.8	29.5	4.3
As percent of C,S, MSVR	36.0%	27.8%	2.5%	20.2%	31.7%	4.1%

1/ After policyholder dividends and before federal taxes.

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