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Financial Aspects of the Automobile Problem

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The "Automobile Problem"

The increasing social and economic importance of the automobile and its attendant private and public cost have worked to place automobile liability insurance in a special legislative and judicial category. This is not a recent development. Fifty years ago, legislatures considered proposals to place the automobile owner in a special financial responsibility status with respect to his legal liabilities. Case law had already developed; legislative proposals then and since have arisen from the general acceptance of the very serious social and economic effects of the automobile on one hand, and on the other, the great gap between the legal responsibility of an owner for accidents and his willingness or ability to be financially responsible.

Since the advent of the automobile, a variety of solutions to fill this gap has been proposed; a fewer number have been tried. Compulsory insurance has been one; financial responsibility laws another. The two represent the bulk of the solutions in the United States. More recently, proposals have been made for compensation systems which, wholly or in part, replace the use of the negligence concept as a basis for the payment of victims of automobile accidents.

Thus we have, today, what is loosely termed the "automobile problem." To some, it is a condemnation of the tort system in terms of its (alleged) inherent delay, unreliability, dependence on juries, failure to encourage rehabilitation, dominance by insurers, high cost of administration, and lack of integrity in general in its treatment of automobile related costs of injuries. Others concur, but emphasize the faults of the physical environment of

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the automobile's use, the adequacy of the highway system, the safety and maintenance of automobiles, the licensing of vehicles and drivers, and the enforcement of motor vehicle laws. Particular emphasis is placed by some on the need for political statesmanship and leadership. The nature of the problem can be defined from the view of many: government, consumer groups, insured motorists, non-insured motorists, manufacturers, and the insurance industry, to mention a few. It is the latter's view which we propose to examine in this paper, with particular emphasis on the ability and/or willingness of insurers to fill the gap between the accident and financial responsibility.

THE "CAPACITY PROBLEM"

We believe it somewhat evident that in a competitive system, wherein insurance companies individually proceed to the public in quest of the sale of profitable insurance, one segment of the market, for a number of reasons, will not purchase. This segment of the market will not purchase because it is not asked to purchase, because it considers the purchase price as exorbitant, or unduly discriminatory, or because it is not financially responsible. A lack of financial resources may also be a crucial reason. The automobile problem in this sense is the uninsured segment of the market.

Much of the controversy concerning automobile insurance centers about the willingness and ability of the insurance industry to offer insurance at a "reasonable" price to this segment of the market (and the entire market, for that matter) in return for a "fair profit." This controversy is termed the "capacity" problem, to connote outward conditions or circumstances under which the insurance industry will supply (half dragged and half lured, perhaps) insurance.[1]

Insurers are placed in an extremely difficult position as financial intermediaries. They recognize that from a practical viewpoint, automobile insurance, generally, is regarded as a form of social insurance. Further, they recognize that there is a political

[1] An excellent point for departing on a study of the automobile problem is C. KULP & J. HALL, CASUALTY INSURANCE (1968), chapters 10, 11, 12, and 13. This is the most complete statement of the automobile problem and its relation to insurers which is presently available.

ceiling on automobile costs, as well as great pressures to provide for more extensive coverage of motorists. Their fear of compulsory insurance law continues, of course, but more important, they seem trapped by their internal structure in a rapidly changing external environment. Internally, they regard automobile insurance as a consistently unprofitable line, and have chosen to control costs through the medium of selective underwriting.[2] While their rate making bases, as promulgated by rating bureaus or their individual devices, may be drawn in a fashion which does not unduly discriminate, their underwriting need not and usually is not drawn randomly from these bases. In many property-casualty lines, individual insurers have "curfews" which either severely restrict the types of risks they will accept or prohibit entirely certain types of risks. These curfews, which comprise a number of underwriting tactics, are well known to sales forces, but are not easy to document. Cancellation, non-renewals, arbitrary rate increases based on accident involvement and other practices are tactics which contribute to the belief of many that insurers do not provide a market (or "capacity") according to the needs of the public.

The insurers justify their practices on profit maximization grounds. They do not consider themselves as public utilities, despite such views by the public. They are unwilling to underwrite without a profit allowance.[3] Expressed in these terms, insurers are financially unwilling to extend themselves by aggressively marketing in currently uninsured areas. To do so would

[2] Insurers have attempted to reduce costs by methods other than selective underwriting. Marketing expense is a notable area.

[3] Some insurers have abandoned this view:

> State Farm has long felt the traditional industry arguments against inclusion of investment income in rate making served only to make regulators and the public suspicious of our motives and operations. Under obscure rituals by which rates are currently approved in accordance with formulae fixing arbitrary profit factors, it is unrealistic to include investment income. But in measuring a company's performance, income from all sources, including investment income, must be considered. . . . Market place competition will require due consideration by management of all relevant factors in the making of rates. Income from investment is certainly one of the most important of these factors. (Testimony of Donald P. McHugh to United States Senate Subcommittee on Anti-Trust and Monopoly, January, 1969. Mr. McHugh is an officer of State Farm Insurance Companies and former Counsel of the Committee.)

be unprofitable. Moreover, they allege their ability to underwrite is, or would be, impaired since their solvency would be questioned. There are these two major dimensions, then, of the capacity problem—financial unwillingness and/or financial inability. Whichever is dominant has major implications for the future of the privately operated automobile insurance industry.

FINANCIAL ABILITY AND INSOLVENCY

It may be that the insurance industry is unable to aggressively market automobile insurance in the uninsured segments because it fears financial insolvency collectively and individually. This raises most difficult questions. One is whether or not underwriting in this segment is unprofitable, and, if so, whether or not the cause is the inability of insurers to price in this segment. The answer to this question involves an intensive analysis of the nature of the ratemaking process as well as insurer motives. While such analysis is pertinent, we propose to treat a question more germane to a financial discussion, that of determining the proper means for evaluating the financial solvency of insurers. Rate regulation, in whatever form, aims at producing a rate structure which is sufficient to cover losses and expenses without endangering solvency. (Other forms of regulation address solvency questions as well.) Despite announced goals of rate regulation to produce a rate structure which is adequate, not excessive, and not unfairly discriminatory, some believe that the causes of insolvency are only related distantly to rate regulation. Other factors, perhaps management dishonesty and incompetence, for example, must play a major role, since it is possible to demonstrate, theoretically, that an increase in rate levels would not appreciably decrease the rate of insolvency. Which factors dominate need not be addressed, yet in any case, determinations of solvency of individual insurers *will* be made by regulatory authorities. What is desired is a measure of solvency which provides assurance of financial ability to respond by the insurer at least in time to detect and prevent loss to the policyholder.

Unfortunately, despite refinements in ratemaking classifications and development of data bases and analytic techniques, tests of financial solvency of insurers are crude, perhaps necessarily so. Three financial measures seem to be used by regulatory authorities, industry analysts, and insurance management: debt/equity, sales/equity, and liability composition and flow measures.

The ratio of debt to equity, so common in financial analysis generally, where debt is considered to be loss reserves and unearned premium liabilities of the insurer and equity as everything in the net worth section (whether the insurer is stock or mutual in form), is said to be a principal administrative tool of regulators. It is basically a leverage measure. As such, it cannot be separated from profitability of any firm, one of the things which influences the willingness of the industry to offer insurance. However, this ratio or variants of it is viewed as surrogate for solvency on the grounds that beyond certain ratios, technical insolvency, arising from regulatory intervention, or even actual insolvency may result from the insufficiency of the equity base to absorb fluctuations in operating experience. The ratio, in insurance terms, measures the number of dollars of insurers' obligations to underlying equity.

Historically, this ratio has been fairly constant for the industry and for most individual insurers,[4] although it rises during prosperity and falls during adverse periods. The problem with the ratio is that it is a crude measure and ignores profitability of the insurance underwritten, the quality of the assets, and due to statutory accounting requirements, the rate of growth of the insurer. The problems associated with its lag alone are almost sufficient to discredit it as a viable surrogate for solvency. Nonetheless, the constancy of the ratio for the industry over time has some interesting implications. One is that insurers have expanded their liabilities only in proportion to the growth of their equity positions, which for the most part has been through investment profits and some underwriting profits. In the last decade there has been practically no infusion of equity funds from the capital markets. The constancy of this ratio has continued during great pressure to expand and innovate in underwriting; in other words, one aspect of the capacity problem, the possible financial insolvency of insurers, cannot be identified in terms of the aggregate obligations of insurers in relation to their net worth. If the danger of financial insolvency were increasing, one might expect

[4] Movements in the ratio reflect changes in underwriting operations as well as investment.

some movement of the ratio to reflect a change in underlying conditions, but none has appeared yet.

The argument can be made that the quality of the liabilities of the insurer is markedly changed, and that this explains the constancy of the debt/equity ratios of insurers over the past years. Support for this view would involve the belief that the potential exposure in stated liabilities, although unrecorded in financial statements, has offset what would otherwise be more debt (underwriting) in the financial structure. Unfortunately, temporal analysis does not support this view. Were liabilities in fact of more volatile character (and skewed on the loss side), their volatility would have resulted in lower unearned premiums and reserves relative to net worth long before now. Of course, the character of an insurer's liabilities are of concern to regulatory authorities, but there is no benchmark or "ratio" connoting solvency or adequacy of unearned premium or loss reserves except the obvious one: are reserves sufficient as they are used up over time? Generally, insurers attempt to establish reserves at a level which is sufficient to meet losses, yet not distort experience of future conditions. Research in this area is sparse for all insurers, but most authorities agree that the administrative rulings and laws governing reserve valuations encourages underreserving[5]—the establishment of liabilities which are less over time than the amount which will be needed for their discharge. Some of this underreserving (primarily of loss reserves) may represent a sort of offset to overvaluation of unearned premium reserves (the latter is inherent in property-casualty insurance accounting conventions). Likewise, some of it may be due to a fear of incurring tax penalties for overreserving, or fear of jeopardizing future rate increases or undue distortion of current earnings figures.[6] Pertinent to this discussion, however, is what we believe to be an obvious implication of the underreserving practice. It seems illogical to argue that insurers fear insolvency (as a reason for not aggressively marketing among uninsured segments) when their practice in establishing reserves is to underestimate. Indeed, one might expect the opposite practice in the face of insolvency fears: overreserving.

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[5] C. KULP & J. HALL, *supra* note 1, at 1016.

[6] Some regulatory authorities believe underreserving is more often than not continued unwarranted optimism of claims managers about future losses.

Fear of insolvency among insurers might be explained to the extent that insolvencies occur at a high frequency in the industry. But, alas, research in this area is fragmentary too. One recent study,[7] admittedly based on limited available data, suggests that while entry and exit to the property-casualty insurance industry may be "high"—as much as 1% annually of the number of companies, and as much as 10% of the companies writing "high risk" automobile insurance—the rate of insolvency is far less, perhaps by one-half. Over the past few years, insolvency seems "normally" to run about 0.5 per cent annually, on the basis of 4,000 companies. More important, unpaid claims as a percentage of total premiums (1960-65) have been estimated at only about $17 million. While this study is replete with caveats concerning the uneasiness of the data base, one might conclude that the rate of insolvency among property-casualty insurers is insufficient as a base to generate widespread fears of insolvency in the industry.

A third measure which is used by many as an indicator of the solvency position of fire-casualty insurers is a ratio of sales/net worth. In insurance terms, premiums written to policyholders' surplus is the measure. Its significance rests on an assumption that liabilities of insurers grow in relation to premiums written and should be evaluated in terms of the underlying equity base. Further, the significance of the ratio rests on an assumption that rapid upward changes in the ratio signals potential financial danger. This ratio is also crude, but purportedly has been proposed as a guideline for inclusion in several state laws as not to exceed 2:1 for automobile insurers and 1:1 for property insurers. But if it is thought of as a measure of the cushion for the volume of unexpected losses, then its historical value is in terms of the direction it suggests for increasing or decreasing solvency of insurers. Without extending ourselves too far with data, one should note that from 1957 to 1967, the ratio of written insurance premiums to policy-holders surplus for *stock* insurers fell from 1.22 to 1.01. Although changes in this ratio also reflect movements in stock market values, the decrease has been significant (there have been no major accounting changes to account for it). Its direction suggests less underwriting; that is, that insurers write less business

[7] W. NORHAUS, INSOLVENCY IN THE INSURANCE INDUSTRY, (1967) (privately published and distributed Working Memorandum No. 22, Case 69021).

now than they did in the past, relative to equity. This is despite much research which has speculated that the ratio should indeed have moved in the other direction, reflecting in some degree the broadening of underwriting powers of insurance companies since 1950. The movement from single-line operation to multiple-line operation should have increased the underwriting capacity of insurers, if for no other reason than on the grounds that additional or broadened actuarial bases become available. For the last year for which data are available (1967) the ratio of premiums written to net worth for *all* insurers was about 1.4. It would appear then that the insurance industry as a whole is not in violation of policyholders surplus "guidelines", but rather is highly conservative relative to historical norms. When one examines large individual companies, the disparity between what they could write in terms of premium volume and what they do write is even greater. Increases in premiums by a magnitude of four or five times present volume is easily conceivable.

The result of such limitation of underwriting, of course, is restricted capacity, with many needed insurance services apparently not being provided or provided in inadequate amounts, and, on the other hand, substantial amounts of capital which are not being utilized to support insurance purposes. Many companies have more capital than they need to support their own insurance operations.

Taking these three measures into consideration (the ratios of debt to equity, and premiums to equity, and those pertaining to under-reserving), can the fear of financial insolvency be cited as a reason for the inability of insurance companies to extend—aggressively market—coverages to the motoring public? Alternately expressed, is there an inability to extend insurance, and is it related to financial insolvency? We think not, to both questions.

FINANCIAL WILLINGNESS

We believe the present capacity problem exists because the industry is convinced that the automobile insurance business is unprofitable, and, further, is convinced it does not have the means to make it profitable. Insurers believe if they aggressively market this business, they would do so at a loss. But operating at a loss to the insurance industry means something different than operating at a loss to others. Insurance company profitability is made up of two elements, underwriting and investment. How well an insurance company does depends on how profitably these joint elements are combined. But, this is where problems arise. Insurance company management insists that it is in the business of providing insurance (narrowly defined to include underwriting but not investing) and so it is entitled to, or rather *must,* make an underwriting profit. The analogous situation in the banking industry can be speculated: a bank should make a profit on the checking services as well as on investing, both for the benefit of stockholders. (Banks seem to have given up in large part the desire for check service revenues in the competition for deposit funds.) What makes insurers particularly distinct from other industries is that the pricing system, regulated after a fashion, has a history of permitting the inclusion of an underwriting profit. The "demand" for underwriting profit is near universal, and is shared and fostered by stock analysts.[8]

The reason insurance company management has this view is simple, when stripped of institutional trimmings. When a manufacturer prices his product (no matter on what basis), he expends resulting revenues on labor, raw materials, and plant and equipment, hoping for a return to equity which is favorable. On the other hand, when the insurer prices his product (no matter on what basis), he expends resulting revenues on losses and expenses *and* on investments, *which in turn* produce revenues. The insurer, too, hopes for a return to equity which is favorable, but differs from the manufacturer in that he has *two* sources of revenue rather than one. Naturally, he attempts (one way or another) to turn a profit from both sources, and becomes (at a minimum) perplexed at those who question his right to do so, or suggest that the sources should be offsetting. The internal structure of the industry is sufficient to assure this managerial attitude will continue for a considerable period in the future.

The prevalence of this belief is so strong that loss of underwriting profit usually results in restrictive underwriting, the development of a capacity problem. When underwriting is restricted, it obviously affects the growth of net worth, which in turn means the business cannot grow through retained earnings.

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[8] Lack of underwriting profit is deemed a sure sign of poor management. The reader is referred to any investment service reports, except for the last year or two.

Is the insurance business, especially automobile insurance, unprofitable? It seems essential to analyze this link in the capacity problem. In response to this question, a number of studies have been made. One, an industry supported study,[9] employed various measures to estimate risk and return to the industry and alleged that the industry is unprofitable and "under earning," in relation to other industries with similar characteristics. Reviews of this particular study have been a trifle scathing in questioning its methodological foundations, statistical analyses, and conclusions.[10] What is curious with respect to this study in particular and other studies of the profit phenomenon or lack of it, in general, is the very conflicting evidence gathered by parties as to the degree to which the insurance industry, particularly automobile insurance, is profitable. Staff reports to legislative committees,[11] testimony by experts and independent studies by academics conflict to the point where a student of the controversy becomes convinced that no course other than additional (his own) investigation can possibly furnish meaningful light on the question.

We do not wish to contribute yet another attempt to answer the profitability measurement question, despite the fact that the profitability level of the industry has profound implications. "Low profits," for example, may be sufficient reason for drastic revision of investment and rate-making laws which apply to insurers, since these laws may be the causes of restricted underwriting and, hence, the basic source of lack of capacity. On the other hand, high profits, however defined, would generate considerable suspicion about insurer motives and the ratemaking process vis-à-vis their public posture to underwrite risks at a "fair" profit. What we believe is important, however, is that the reader appreciate the

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9 PRICES AND PROFITS IN THE PROPERTY AND LIABILITY INSURANCE INDUSTRY, A REPORT TO THE AMERICAN INSURANCE ASSOCIATION (1967).

10 Hammond & Shilling, Report Review, 36 J. RISK & INS. 129 (1969); Hofflander & Mason, Report Review, 35 J. RISK & INS. 293 (1968); R. Norgaard & G. Schick, *Profitability in the Property and Liability Insurance Industry*, Dec., 1968 (unpublished manuscript, University of Southern California).

11 STAFF OF ANTITRUST SUBCOMM. OF THE COMM. ON THE JUDICIARY, HOUSE OF REPRESENTATIVES, 90TH CONG., 1ST SESS., AUTOMOBILE INSURANCE STUDY (1967); *Hearings Before the Antitrust and Monopoly Subcomm. of the Senate Comm. on the Judiciary*, 90th Cong., 2nd Sess. (1968). In C. KULP & J. HALL, *supra* note 1, the author repeatedly refers to the unprofitability of casualty insurers. Another government study, on the other hand, apparently authored by academics, considers the industry as profitable. *See* PRESIDENT'S NATIONAL ADVISORY PANEL ON INSURANCE IN RIOT-AFFECTED AREAS, MEETING THE INSURANCE CRISIS OF OUR CITIES (1968).

nature of the questions which must be addressed to examine the profitability of any industry.

Initially, profitability can be measured on a number of bases: the rate of return on total assets or equity (market value or book value?), or on sales (underwriting: premiums written or premiums earned?); performance of the common stocks of insurers is another logical base (capital gains and/or dividends? How does one weight the components?). If the interest is in the profitability of the automobile insurance industry, then questions arise as to how profitability should be measured for mutual insurance companies, where no market values for equity appear and where dividends to policyholders may be a practice. Indeed, can profitability of automobile insurance be studied separately from all insurance? In any event, can the operations of insurers be studied effectively at all with respect to profitability without submerging the automobile insurance portions?

Presuming these questions can be or are answered to the satisfaction of a majority, can comparative profitability be established in reference to the returns "in other enterprises having corresponding risks?" The problems in defining corresponding risks are not new (public utility regulators have struggled in this area), but they are most minor as problems compared to those of developing statistically (and convincingly) a measure of risk. If statistical data are used, should they be temporally or spatially developed in their measure of risk and return, and over what time periods? Should they involve simple means or variances, or more sophisticated measures of risk? Finally, when completing consideration of such risk-return relationships, do "conclusions" emanating reveal no more than differences in managerial ability or "true" risk-return differences, intra-industry and inter-industry?

Profitability conclusions must be interpreted in terms of an assumption about the nature of insurance company management. Suppose that insurance management is highly homogeneous, particularly the stock fire and casualty segment, and has followed not some maximizing behavior in profitability decision-making, but some sort of an institutional behavior, reflecting its views of what should be the underlying characteristics of its common stock equities (mutual company management may operate similarly) in terms of risk-return characteristics. This supposition would mean that all insurance company managements (consciously or otherwise) have aimed at producing common stock values in the market which have the same risk-return characteristics. (For the image it leaves with the regulatory authorities might be one explanation for this behavior.) If this were the case, then risk-return analysis, based on market value performance of the underlying equities, would largely be meaningless, insofar as it would be self-inflicted.[12]

These questions are meant to be only suggestive and not exhaustive. They should reveal that there are no simple answers to the profitability questions, despite their profound implications to the insurance environment.

What seems very peculiar in the flurry of studies, data and criticisms on the profitability of this industry, particularly with respect to the automobile segment, is the scant attention currently given to the performance of common stocks of insurance companies and the implications of the widespread financial reorganizations. Each of these deserves some comment.

The ultimate test of profitability must be in the market place, at least for stock insurance companies. It is perplexing to note again and again in the press, and in insurance company statistical services, that property-casualty insurers have had a period of underwriting grief since about 1955. Yet, rising market prices of their asset portfolios and the attendant rising investment income have managed to finance more than a doubling of assets, surplus and premiums. "Thus, despite profitless underwriting, the industry has enjoyed a measure of prosperity and has been able to maintain a generally sound financial structure."[13] The market for insurance company stocks has reacted. We chose not to present a statistical study of the phenomena, but the Best Insurance Stock Index (30 stocks, 1956-66) has had an annual growth of approximately 9% per year, while Standard and Poor's 500 stocks has grown an average of 5.5% per year. Others have claimed that large multiple line as well as specialty automobile insurance companies have made exceptionally high average profits, based on a study of 641 major American non-insurance companies and 25 insurance

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[12] Such a theory of institutional behavior is suggested, not posited, in Michaelson & Goshay, *Portfolio Selection in Financial Intermediaries: A New Approach*, 2 J. FINANCIAL & QUANTITATIVE ANALYSIS, (1967).
[13] Preface to BEST'S DIGEST OF INSURANCE STOCKS (36th ed. 1966).

companies over the 1953-67 period.[14] On the other hand, from this same study, the average *trend* in insurance profits seems to be down over the past 15 years, being most pronounced among automobile insurance underwriters. Yes, the data, studies and criticism conflict.

We seem to reach necessarily the conclusion that the profitability question is unresolved. What appears to be happening is that several groups are trying to demonstrate that the industry is not profitable, possibly for political and regulatory reasons, while other groups—mostly consumer and academic in composition—are claiming it is profitable, or that the conclusions of the former are in error, without developing the "true" picture. Underlying, of course, is a continued and acknowledged condition of the industry: lack of capacity.

Financial reorganizations have played a prominent role in the insurance industry over the last decade, particularly the last few years. Mergers between insurance companies have been several, but mergers between insurers and non-insurers have been conspicuous. In fact, much of the favorable performance of the common stocks of insurers over the last few years has been of a speculative nature, related to the formation of insurance holding companies and their subsequent merger with industrial and financial conglomerates.[15] Does this phenomenon relate to the profitability of insurance companies and to the lack of insurance capacity? We think it does. The explanation of the merger-holding company "movement" in the property-liability industry must be based on some sort of mutual attraction. It appears to us that this attraction is to a large part a function of different perceptions of the profitability of insurance companies, and that this difference in perception may well be a crucial issue.

Foremost among these perceptions is that the property-liability industry believes its earnings record has been consistently substandard, has worsened substantially in recent years, and is not likely to improve in the foreseeable future. The market price of

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[14] R. Norgaard & G. Schick, *supra* note 10.

[15] The spectacular gains of common stocks in the property-liability field in 1968 were sparked by takeovers and mergers. Best's Property-Liability Stock Index surged ahead by 72.5% compared with a loss of 24% in 1967. Big gainers were Great American Holding, Gulf Insurance, Hartford Fire, American Reinsurance, and Continental Corporation.

property-liability insurance company stocks has reflected the depressed level of earnings as perceived by management and insurance stock analysts. In many instances the price of insurance company common stocks have been selling below their liquidating value.[16] This encouraged individuals and companies to seek to purchase such stocks at bargain prices to gain access to insurance company assets. Following this line of reasoning to its logical conclusion, what one might expect to be happening would be that each insurance company taken over through a merger or by conglomerate acquisition would be liquidated in order to pirate its assets. As a matter of fact, this has not occurred in the majority of instances if any. What has happened is that the acquired companies have had their "excess surplus" drained down to some minimum level.[17] The resulting funds are then passed on to the parent company for reinvestment elsewhere.

It is possible for one to draw at least two conclusions from what is occurring. First, in the minds of those who are seeking to acquire insurance companies, the insurers are over-capitalized. As such, they are an excellent source of instant funds (excess surplus). The second conclusion arises from the absence of liquidation: the acquiring firm must view the insurance company as being useful (*i.e.* profitable) as an ongoing firm as well as a source of instantaneous cash. If it did not feel this way, it would be advantageous to liquidate the firm and turn all assets into cash.

The present wave of mergers between insurance and non-insurance firms is aggravated, to a large extent, by the fact that non-insurance enterprises are facing a period of high capital costs.[18] Therefore, industry is searching for alternative sources of capital which have a lower market cost. What industry sees is that insurance company funds are or can be very low cost (negative cost?) in nature.[19] The insurance company is viewed as a levered

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16 At the beginning of 1968, property-liability shares were quoted at an average of only ten times net investment income and less than book value. BESTS INSURANCE STOCK TRENDS (1969).

17 "Excess surplus" or "surplus-surplus" refers to that amount of net worth which is thought to be greater than needed for the amount of insurance (and hence debt) being underwritten. Such companies are referred to as underlevered or overcapitalized.

18 There are a number of motives, of course, for merger, but high capital costs are very significant.

19 The parenthetical insert in the sentence reflects the obvious condition under which the insurer raises investment funds and realizes a profit on the func

(Continued on next page)

investment trust in which policyholders are putting up substantial amounts of cash as a by-product of purchasing the insurance. To the extent that firms can make use of this capital, they can do so at a relatively low cost.

Thus what one had was the insurance industry with its stock selling below liquidating value, overcapitalized, and a ready source of low cost funds, but restricted as to the types of investments it could make. When other segments of the economy are in need of capital funds, and when these capital funds are expensive, the resulting conclusion is almost foregone: merger through the holding company.

Many in the insurance industry, including regulators, are concerned with the resulting financial reorganizations and their implications for the operation of insurance companies in the future. They view the drawing down of excess surplus as intensifying an already dangerous capacity problem. Differences in perception abound, but we do not see dangers to solvency. Indeed, what assets are left supporting insurance may be used more efficiently, relative to the past. We believe the major implication of the trend is not so much the solvency matter as it is the profitability matter. Insurance must be considered as profitable, but perhaps not with respect to particular lines of business.

Will the movements afoot in the industry result in more capacity? We hardly think so. True, there will be management changes arising from the merger-holding company movement. Perhaps this will include a healthy infusion of new and better management philosophy. And undoubtedly, there will be complementarity of financial operations. However, the movement does not seem to envision one management taking over from another to "turn around" the "unprofitable" insurance business. There may be additional insurance written, but it will be more of the same type; insurers in the merger-holding company arrangement will be competing for shares of the same business which is currently being written, and not aggressively underwriting new business. We do not believe that the insurance companies, as part of these conglomerates, will be operated to maximize conglom-

(Footnote continued from preceding page)
raising process. In effect, insurers can raise "debt" funds at a negative cost, by underwriting profitably.

erate profitability without the interests of the public, but merger managers are aware that insurers have the unique capability of raising capital funds from other than capital markets at reasonably low cost. Managements cannot be expected to jeopardize the low cost feature by experimentation with new forms or areas of underwriting. Curtailing insurance activities until they are profitable is logical. If the unprofitability is perceived as a long-run phenomenon, management's duty to stockholders is to remove a portion, if not all of their assets from insurance commitments to more profitable commitments.

SUMMARY OBSERVATIONS

We are forced to conclude that lack of capacity in the insurance industry is not based on the inherent profitability of the risks which are currently underwritten or on a fear of insolvency. Investors in insurance companies must be considered to have maximizing motives which are similar to investors in other industries. Such motives, while not anti-social, have resulted in capital movements away from support of insurance underwriting in favor of more profitable or less complicated ventures. Some may consider this to be an abrogation of social responsibility, to the extent that investors and management have decided to limit their commitments to furnishing insurance, aggresively, or otherwise. But, we perceive the investment market as a resource allocator which is currently undertaking change. In large part, this change may be triggered by perceived lack of profits, inertia of marketing forces, impatience with the (price) regulatory process, competition, and other factors which represent the growing and complex environment of the industry. We find nothing surprising in this development. It involves no more than classic opportunity costs.

On the other hand, we think the industry collectively is not aware of the consequences of its Adam Smith-type decision making, or if it is, it is unable to act collectively about the consequences without a serious time lag. Individual decision making by insurers has a collective impact. We see it reflected in the automobile insurance segment of the industry in the rash of proposals in recent years—being considered far more seriously than in the past—for a modification of the means of providing payments to victims of accidents. The industry is involved causally in this mat ter, at least in part. We see it as well in the property insurance segment of the industry in plans—currently operating—which provide a market for risks otherwise not placeable in the "normal" markets. These plans came on-stream after Congress in mid-1968 passed legislation which established reinsurance mechanisms at the federal level if the industry, in turn, established vehicles for insuring risks which could not be placed in the normal market. State programs have developed, as have urban area plans. We have also seen nuclear liability insurance, foreign credit insurance, mortgage guarantee insurance programs, among others, develop under federal auspices. From this pattern, the industry must realize that its decision-making, when it is deemed to create, to contribute to, or to reflect an inability to respond to critical insurance problems, will result in national and state solutions.

It is not exactly correct to note that in the past the insurance industry has solved its critical problems by joining together with government to attain social goals. Government has enjoined industry to solve its problems. There are some who have every conviction that a similar pattern will develop in automobile insurance. But the reasons for government partnership in the past have generally been because the risks insured have been unpredictable and catastrophic, not because insurers were unwilling to underwrite for profit reasons which now seems to be the case. The automobile problem seems clearly to involve this unwillingness (as did the medical care for the aged problem). The distinctive aspect of the automobile problem is that any future partnership involves a good portion of the industry's premiums, whereas previous partnerships have not appreciably concerned the industry's premiums. Thus, a partnership involves serious precedence with respect to the revenues of the industry and the insured and uninsured segments of the market.