

Order Code IB86154

THE LIABILITY INSURANCE CONTROVERSY

Updated May 1, 1987

by

David Whiteman

Economics Division

Congressional Research Service

CONTENTS

SUMMARY

ISSUE DEFINITION

BACKGROUND AND ANALYSIS

THE LIABILITY INSURANCE CONTROVERSY

SUMMARY

Liability insurance, as the primary method of managing business-related risks, has been recognized as one of the foundations of American commerce. In recent years insurance market difficulties involving the price and supply of commercial liability insurance, in combination with tort liability law issues, have developed into a serious and perplexing national controversy. The effects of these problems cut across virtually every sector of the economy, affecting most segments of American society, and have resulted in intense expressions of public concern. There has been considerable legislative activity at the Federal level and much legislative, administrative and study activity at the State level as policymakers have struggled with the complexities of trying to determine what went wrong and how to fix it. What role and what actions may be appropriate federally is not clear because tort law and insurance regulation -- major components of the problem -- have traditionally been administered by the States. A variety of remedial measures has been taken by the States but there is as yet no consensus at the Federal level for legislation that would address underlying causes of recurring insurance problems, and constituent pressure for relief and reform remains strong.

ISSUE DEFINITION

Liability insurance, as the primary method of absorbing or managing personal and business-related risks, has been recognized as one of the foundations of American commerce. In recent years insurance market difficulties involving the price and supply of commercial liability insurance, in combination with tort liability law issues, have developed into a serious and perplexing national controversy. The effects of these problems cut across virtually every sector of the economy, affecting most segments of American society, and have resulted in intense expressions of public concern. There has been considerable legislative activity at the Federal level and much legislative, administrative and study activity at the State level as policymakers have struggled with the complexities of trying to determine what went wrong and how to fix it. What role and what actions may be appropriate federally is not clear because tort law and insurance regulation -- major components of the problem -- have traditionally been administered by the States. A variety of remedial measures has been taken by the States but there is as yet no consensus at the Federal level for legislation that would address underlying causes of recurring insurance problems, and constituent pressure for relief and reform remains strong.

BACKGROUND AND ANALYSIS

With premiums for business liability insurance soaring and coverage very difficult to obtain for many lines of business, the commercial insurance industry in 1985 and 1986 was described by many observers as "in crisis." This situation has placed severe economic pressures on a wide variety of professions, industries, public entities and organizations in many so-called "distressed lines" of business, including: liability for manufactured products, medical malpractice, long-haul trucking, municipalities, officers and directors, child care facilities, commercial fishing vessels and a host of other classes of business where affordability and availability of property-casualty insurance is an acute problem. The Congress has been besieged with complaints regarding huge rate increases, mass cancellation of coverage, and entire lines of insurance virtually unavailable at any price. The ensuing controversy has brought insurance, as a public policy issue, to the verge of a rare national debate over the nature of the industry, its role in the economic life of the Nation, and whether the Federal Government should pursue a more active oversight or supervisory role with respect to insurance industry operation and regulation.

Continuing insurance problems involving very high premium rates and limited amounts of available coverage, in large part, stem directly from very substantial losses suffered by insurers. The American property-casualty insurance industry and the Lloyd's of London underwriters who have provided a principal reinsurance market for this business, by spreading risks on a worldwide basis, suffered record underwriting losses in 1984 and 1985. The domestic property-casualty industry reported operating losses (a combination of underwriting results and investment income, before payment of taxes) of \$3.8 billion in 1984, and \$5.4 billion in 1985. The deficit was substantially narrowed,

however, by tax credits and capital gains on sales of investment securities. Severe underwriting losses shrunk insurance capacity, the amount of working capital on hand that determines the volume of business an insurer can legally write. Varying degrees of financial impairment among property-casualty companies has been widely reported and State regulatory officials are concerned that insurer insolvencies are running at levels unprecedented in the modern history of the industry.

The insurance controversy, for the most part, is limited to a variety of commercial liability coverages. Commercial property coverage has also been affected, but to a lesser extent. All forms of personal lines coverages continue to be written in a generally competitive environment with limited price and supply problems. Commercial liability insurance accounts for roughly 10% of total property-casualty business operations. However, this type of coverage has been demonstrated to be vital to the economic life of the Nation and the severe underwriting losses for commercial liability have had a very substantial impact on insurers' financial performance and subsequent underwriting and pricing practices.

The causes of the liability insurance "crisis" are many. The inability of insurers to price premiums when they cannot define the extent of risk is said to be of major importance. The insurance industry contends that realistic underwriting (risk assessment and pricing) for commercial liability risks is very problematic largely because of case law developments (as opposed to statutory changes) in the field of tort litigation and the extent of monetary damages sought and sometimes awarded. Tort law determines who is responsible and what damages shall be paid when injuries and/or negligence are claimed. Insurers contend that generally acceptable rules of fault prevailed in the United States until the right to claim damages was widely expanded in the last 25 years. Cost uncertainties engendered by the legal system have, according to the insurance industry, made true liability costs difficult to calculate or project when insurers cannot measure or predict what degree of liability they may face in future years. This is particularly the case for risk exposure that may not now be apparent and for which the courts may eventually hold insurers liable.

The insurance industry has been accused of blaming the tort system for its problems to divert attention from what has been termed the industry's own poor management record. Property-casualty companies in recent years priced their policies far below cost to attract funds for their investment income programs. Then-prevailing high interest rates on investments compensated for insufficient premiums. Now that interest rates have dropped to the point where investment returns are not able to cover growing underwriting losses, industry critics argue that insurers are trying to recoup losses too quickly with unreasonable rate increases, and are seeking government protection through tort law reform as well. Industry critics are also concerned that much economic data on the industry can come only from industry sources. A number of policymakers have expressed discontent concerning the degree of industry control and interpretation of industry financial information. Several insurance data reporting requirements bills were introduced in the 99th Congress but did not advance.

In the United States, insurance has traditionally been regulated at the State level with limited Federal oversight of the adequacy and effectiveness of such regulation. Consequently, insurance problems are now an important issue for State legislatures and officials and, much remedial activity is in progress. But because of the severity of the insurance crisis and because insurance problems are national in scope, congressional interest and scrutiny have grown accordingly. There appears to be increased public awareness that liability insurance is an essential financial service and mounting concern that the market for this insurance lacks a reasonable degree of stability. To some extent, the recent insurance crisis may be viewed as a repetition of prior experience. It is universally recognized that property-liability insurance is cyclical with alternating periods of expansion and contraction. The periodic "boom-and-bust" market cycles that typically and historically have characterized property-casualty insurance industry operations have been shown to be seriously disruptive to the economic life of the Nation. During the legislative focus on insurance issues in the 99th Congress a number of policymakers expressed the view that insurance-related problems may need to be addressed on a national scale, and that the public, as well as the business community, requires the maintenance of a reasonably orderly and reliable insurance mechanism.

In 1985 and 1986 a large number of congressional committees held hearings and took testimony critical of the industry concerning continuing problems of insurance availability and affordability. This hearing activity has prompted the Congress to begin to:

- (1) investigate new ways to promote a more stable insurance marketplace, averting future sharp fluctuations in the price and supply of commercially necessary or legally required forms of insurance protection;
- (2) review the adequacy and effectiveness of State insurance regulation and question the rationale of continued State supervision of the insurance industry -- on this subject, a few voices have been raised within the industry itself urging an examination of Federal insurance regulatory initiatives; and,
- (3) examine the basic precepts of the U.S. civil justice system (based upon insured tort liability) that may exacerbate insurance cost problems.

A CRS Report (Report no. 87-97 E) cited under ADDITIONAL READING, below, identifies and discusses the major insurance reform proposals in the 99th Congress. From the large number of these initiatives only "The Risk Retention Act of 1986" (S. 2129), P.L. 99-563, was signed into law. The measure allows business, professional, public service and other groups to more easily form cooperatives to either provide or purchase liability insurance. Such "risk-retention" groups can supply their own liability insurance through pooling associations or use their collective marketing power in group purchase arrangements. The appeal of this initiative was attributable, at least in part, to the fact that it did not involve tort

reform nor require members to make judgements concerning the adequacy and effectiveness of State insurance regulation.

Over the years the State-supervised insurance industry has developed into a complex community of institutions with impressive expertise and strongly perceived interests. In general, insurers appreciate the regulatory flexibility afforded by the current multijurisdictional system and have expressed sharp opposition to a more substantial Federal supervisory role. The industry defends its historical record of performance including responsiveness to public and business needs. In this view, the State regulatory process offers the opportunity for creative responsiveness to varying market conditions providing optimal allocation of coverage price and supply. In acknowledging the severe liability insurance crisis of the past 2 years, insurance industry spokesmen generally concede a problem of national moment but caution against overreaction that may impair the industry's ability to serve the Nation's insurance needs responsibly and creatively. They note the easing of some insurance availability problems due to responsive workings of the market and point out that insurance industry performance compares favorably with other large-scale domestic financial service industries in the very unsettled business environment of this decade.

The following insurance issues are emerging as the focus of legislative attention thus far in the 100th Congress:

- Continuing market problems involving the price and supply of necessary forms of liability insurance;
- The insurance industry's antitrust immunity and federal oversight considerations under the McCarran-Ferguson Act of 1945; (See CRS Issue Brief 86149)
- Mandatory insurance data reporting requirements; and
- Measures that would exert countercyclical influence to control extreme market fluctuations.

Senator Metzenbaum has introduced S. 80, a bill to repeal the McCarran-Ferguson Act of 1945. Following hearings on Feb. 18, 1987, it has been reported that revisions to the bill may be considered that would modify only the anti-trust immunity provisions of the Act. Senator Simon has introduced S. 804, a bill to modify only the antitrust exemption of McCarran-Ferguson and allowing some collective activities as defined by the bill. This proposal is based upon recommendations made in 1979 by the bipartisan National Commission for the Revision of Antitrust Law and Procedure. The bill would allow collection and exchange of loss data and the joint underwriting of large risks, but would prohibit the exchange of data concerning companies' cost of doing business. The bill would also give the Federal Trade Commission (FTC) authority over companies engaging in deceptive trade practices. Other McCarran modification or repeal measures are expected to be introduced later in the first session of the 100th Congress. A form of McCarran modification initiative currently under discussion would identify certain prohibited joint activities of insurers and allow non-prohibited collective activities. This approach is

the reverse of Senator Simon's bill that identifies permissible joint activities and prohibits all others.

The trend of recent years has been toward deregulation of market activity and reduced Federal activism in the economy. Thus, as initiatives develop into specific remedial proposals, especially those involving substantial systemic changes in the organization, operation and regulation of insurance, substantial opposition to these proposals may well arise.

FOR ADDITIONAL READING

U.S. Library of Congress. Congressional Research Service. Insurance industry regulation and supervision: a reexamination of the McCarran-Ferguson Act of 1945 [by] David Whiteman. [Washington] 1986. (Updated regularly)
CRS Issue Brief 86149

----- Liability insurance and tort liability reform: legislative proposals in the 99th Congress, by Edward Rappaport and David Whiteman. Feb. 5, 1987. [Washington] 1987. 18 p.
CRS Report 87-97 E

----- Liability insurance availability and affordability problems as a function of property-casualty insurance market fluctuations, by David L. Whiteman. June 28, 1985. [Washington] 1985. 7 p.
CRS Report 85-626 E

----- Liability insurance: bibliography-in-brief, by Felix Chin. [Washington] June 1986. 4 p. (L0685)

----- Liability insurance issues: editorial commentary, by Congressional Research Service, Library Services Division. [Washington] April 1986. 28 p.

----- Products liability: a legal overview [by] Henry Cohen. [Washington] 1987. (Updated regularly)
CRS Issue Brief 77021

----- Property-casualty insurance market operation, by David L. Whiteman. Mar. 20, 1985. [Washington] 1985. 14 p.
CRS Report 85-629 E

----- Tort reform and liability insurance [by] Henry Cohen. [Washington] 1986. (Updated regularly)
CRS Issue Brief 86108