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STATEMENT OF

WILLIAM J. ANDERSON, DIRECTOR

GENERAL GOVERNMENT DIVISION

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

COMMITTEE ON WAYS AND MEANS

HOUSE OF REPRESENTATIVES

ON

PROFITABILITY OF THE PROPERTY/CASUALTY INSURANCE INDUSTRY

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Mr. Chairman and Members of the Subcommittee:

We are pleased for the opportunity to assist the Subcommittee in its deliberations on the subject of the insurance industry. We have been actively involved in this area for the past 6 years. In 1981 we reported to the Congress on taxation of life insurance companies, and in 1985 we reported on taxation of the property/casualty insurance industry. We have testified several times before House and Senate Committees and have provided them with additional information on related issues, including the financial status of the industry.[1]

It is this status that we will address in our remarks today. In this regard, I will provide some background information on property/casualty company pricing strategies, a financial overview of the industry, and the financial impact of certain liability insurance lines.

PROPERTY/CASUALTY COMPANY PRICING STRATEGIES

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

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[1]See attachment I for list of GAO studies and testimony.

The ability to offset underwriting losses with investment income plays an important role in a company's pricing strategy--that is, the amount it charges for the insurance that it offers. For a number of years, many companies have been willing to accept lower premiums in order to compete for certain insurance lines, even though claims and expenses exceeded the premiums. As a result, claims and expenses in 1984 exceeded premium revenues by more than 18 percent.

The companies, however, expect to make up the premium shortfall through investment income. Through the incremental volume of premiums resulting from this pricing approach, companies are able to generate a larger amount of net cash flow which they can then invest to earn additional investment income. For instance, in 1983 the industry's claims and expenses exceeded premiums by about 12 percent, which produced an underwriting loss of about $11 billion. Even so, the industry had a net gain of about $8 billion and generated a total of about $12.1 billion in net cash flow, due to its pricing strategy and investment income.

In past years, investment gains, in the aggregate, have exceeded underwriting losses by a fairly wide margin. However, the gap has been narrowing in recent years and disappeared in 1984, when underwriting losses for the industry were $19.4 billion, while the investment gain was $17.9 billion. Some companies have reacted to this situation by sharply raising premiums.

FINANCIAL OVERVIEW OF THE PROPERTY/CASUALTY INDUSTRY

We developed a financial overview of the property/casualty insurance industry by studying financial data for the 10-year period, 1975 through 1984. We obtained these data from Bests' Aggregates and Averages. While Bests' reports omit figures for many small or new companies, we believe that the data are representative of the overall financial results of the property/casualty industry.

In tables 1 and 2 we show sources of income, broken out by underwriting gains, investment gains, and total gains. We also show disposition of income, broken out by the increase in surplus, dividends to stockholders, and the combined total. Federal income taxes are also shown.

We show in table 1 that, while property/casualty companies had about $46 billion in underwriting losses from 1975 through 1984, they also had about $121 billion in investment gains during this period, resulting in a net gain of about $75 billion for those years. From 1975 through 1984, federal income taxes were a negative $125 million, a rate of minus 0.2 percent of the net gain.

Table 1

All Companies -- Consolidated Basis
1975 through 1984
(in billions of dollars)

Underwriting gains (loss)	Investment gains	Net gains	Federal income tax	Percentage of federal income tax to net gains
($45.8)	$121.0	$75.2	($0.125)	(0.2)

Table 2 shows that about $48 billion of property/casualty companies' income from 1975 through 1984 was used to increase surplus, and $18.5 billion was paid to stockholders in the form of dividends.

Table 2

All Companies -- Consolidated Basis
1975 through 1984
(in billions of dollars

Increase in surplus	Dividends to stockholders	Total
$47.8	$18.5	$66.3

Tables 1 and 2 show that from 1975 through 1984 the industry as a whole, in spite of its underwriting losses, had positive net gains, yet had a negative federal income tax rate in relation to its net gains.

While firm figures for the industry's financial performance in 1985 are not yet available, Best's Insurance Management Reports, dated December 30, 1985, contains some estimates. For a number of reasons, including the pricing strategies referred to earlier, the underwriting losses in 1984 reached record highs and it appears that this will also be the case for 1985. However, as shown in table 3 below, the investment gains have also been increasing. The result is that the 10-year figures for 1976 through 1985 (based on estimated 1985 data) tell the same story of relatively high gains with overall negative taxes.

Table 3

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

Underwriting gains (loss)	Investment gains	Net gains	Federal income tax	Percentage of federal income tax to net gains
($65.2)	$140.2	$75.0	($1.5)	(2.0)

It should be noted that the net gains, shown in table 3 for the 10-year period ending in 1985, are almost identical to those shown in table 1 for the 10-year period ending in 1984. However, because of the losses reported for tax purposes for 1985, the negative income taxes have risen from $125 million to about $1.5 billion.

Two explanatory notes about the above figures for investment gains and underwriting losses are appropriate. First, the investment gains include net investment income and both realized and unrealized capital gains. We recognize that unrealized gains may be wiped out in a following year. However, in compiling our figures we cover a 10-year period--a time frame sufficiently long to produce an average for those gains.

Second, the underwriting losses do not reflect policyholder dividends. We consider these dividends to be voluntary distributions by the companies.

The foregoing tables show that over the 10-year period, from 1976 to 1985, the investment gains of the industry exceeded the underwriting losses, giving the companies a net gain before taxes of $75 billion. However, it should be pointed out again that in the most recent years there has been very little, if any, excess of investment gains over underwriting losses.

Cyclical Nature of the Industry

While we believe it is important to look at the figures for the most recent years, we also believe that the industry is particularly subject to profit and loss cycles. For that reason we believe that data covering longer periods gives a more complete picture of the industry's profitability.

Unlike most other industries the property/casualty insurance industry is flexible with respect to capacity. When times are good, insurance companies can increase their capacity, take varied and greater risks, and generally lower their premium rates in order to achieve a greater market share. This results in a change from favorable premium profit margins to unfavorable margins, resulting in profit and loss cycles. Thus, the industry pricing strategy can result in financial cyclicity.

Attachment II shows the year-by-year figures for underwriting gains and investment gains for the 12-year period from 1974 through 1985. Column 1 in that table, underwriting gains, illustrates the cyclical nature of the industry. The earlier cycle bottomed out in 1975 and peaked in 1978. Since 1980, underwriting losses have mounted again but are estimated to have bottomed out in 1985.

Financial Outlook for the Industry Appears Favorable

From all indications it seems that the trend towards larger and larger underwriting losses has peaked. Industry estimates that have been made available to us show that over the next 5 years the industry expects substantial net gains. Our calculations, made from industry estimates, indicate an expected net gain before taxes of over $90 billion for the years 1986-1990.

Others also predict favorable prospects for the industry. An August 1985 study by Salomon Brothers, Inc.,[2] forecasts that premiums written will grow at a 12 percent annual rate over the 1985-1989 period. The same study forecasts a 10 percent growth rate for incurred losses over the period and improved underwriting results. The study forecasts further that industry profits will rise annually at a rate of 25 percent for 1985-1989 corporations over the same period. More recently, the Best's

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

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

IMPACT OF LIABILITY LINES

The lack of availability of property/casualty insurance does not apply across the board to all lines. Rather it is found principally in certain liability lines. These lines do not represent a major portion of the total property/casualty insurance business.

Two of the insurance lines often mentioned in the context of high premiums and lack of availability are medical malpractice and general liability. The following table shows, for the years 1984 and 1985, the relationship that these two lines have with respect to the total property/casualty industry.

Table 4

Financial Results
Property/Casualty Industry - 1984 and 1985
(in billions of dollars)

	Written premiums	Premiums as a percent of total industry	Under-writing losses[a]	Losses as a percent of total industry
Total Industry:				
1984	117.7	100.0	21.5	100.0
1985	142.3	100.0	25.2	100.0
Medical Malpractice:				
1984	$1.8	1.5	$1.1	5.1
1985	2.6	1.8	1.4	5.6
General Liability:				
1984	6.5	5.5	3.2	14.9
1985	11.1	7.8	4.6	18.3

[a]Underwriting losses after policyholder dividends.

The figures in this table show that these two lines represent a relatively small portion of the industry. The medical malpractice share of the industry's premiums is less than 2 percent and it constitutes about 5 percent of the industry's losses. Similarly, the general liability share of the industry's premiums is about 6 percent and it constitutes about 16 percent of underwriting losses. It should be noted, however, that for certain companies that specialize in these liability lines the percentage of the proportion of the losses will likely be higher.

It should also be noted that these two liability lines represent proportionately more of the industry's investment gains than of the industry's premiums. For example, medical malpractice lines constitute about 6 percent and general liability lines constitute about 14 percent of the industry's investment gains.

CONCLUSION

In conclusion, Mr. Chairman, available financial information for a recent 10-year period indicates that the property/casualty industry is cyclical in nature. The data further indicates that over this period the industry has been profitable. The profitability has been lower in more recent years; however, the industry projects increasing premium volumes and more favorable prospects for the next few years. The data also show that while medical malpractice and general liability insurance have received considerable attention recently, they represent a relatively small portion of the industry overall.

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

GAO STUDIES AND TESTIMONIES REGARDING THE INSURANCE INDUSTRY

September 1981 - December 1985

Reports and Fact Sheets

"Billions of Dollars Are Involved In Taxation of the Life Insurance Industry--Some Corrections in the Law Are Needed" (PAD-81-1, September 17, 1981)

"Modified Coinsurance and Its Use by Some Life Insurance Companies to Reduce Taxes" (PAD-82-33, April 14, 1982)

"Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry" (GAO/GGD-85-10, March 25, 1985)

"Information on How the Property/Casualty Insurance Industry is Taxed" (GAO/GGD-86-16FS, October 16,1985)

"Information on the Stock and Mutual Segments of the Life Insurance Industry (GAO/GGD-86-31FS, December 12, 1985)

Testimony

March 18, 1982 on Life Insurance Taxation before the Senate Finance Committee

May 10, 1983 on Life Insurance Taxation before the Subcommittee on Select Revenue Measures, House Ways and Means Committee

June 13, 1983 on Property/Casualty Insurance Taxation before the Senate Finance Committee

May 17, 1985 on Property/Casualty Taxation, statement for the record for the Subcommittee on Economic Stabilization, House Banking, Finance, and Urban Affairs Committee

July 19, 1985 on Property/Casualty and Life Insurance Taxation before the House Ways and Means Committee

October 1, 1985 on Property/Casualty and Life Insurance Taxation before the Senate Finance Committee

ATTACHMENT II

UNDERWRITING GAINS, INVESTMENT GAINS, COMBINED UNDERWRITING AND INVESTMENT GAINS, AND FEDERAL INCOME TAX

ALL COMPANIES -- CONSOLIDATED BASIS

YEARLY 1974-1985

(In millions)

Year	(1) Under-writing gains	(2) Investment gains	(3) Total (1) + (2)	(4) Federal income tax
1974	(1,974)	(2,443)	(4,417)	(325)
1975	(3,653)	7,009	3,356	(555)
1976	(1,726)	7,173	5,447	148
1977	1,926	5,063	6,989	1,015
1978	2,548	7,758	10,306	1,389
1979	24	11,610	11,634	896
1980	(1,712)	15,870	14,158	593
1981	(4,464)	10,858	6,394	55
1982	(8,303)	18,387	10,084	(716)
1983	(11,088)	19,441	8,353	(1,218)
1984	(19,379)	17,875	(1,504)	(1,732)
1985*	(23,100)	26,200	3,100	(1,900)

*Estimate.