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ALL-LINES ORGANIZATIONS—THE INTERSECTION OF THE LIFE AND CASUALTY OPERATIONS

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1. All-Lines Charters

   What are the financial advantages and disadvantages of All-Lines Charters? How would state guarantee associations be affected?

2. Tax implications

   a. Adding casualty lines to a company taxed for life.
   b. Adding life lines to a company taxed as casualty.

3. Future marketing implications

   a. Combination products
   b. Agent compensation
   c. Others

4. Future capacity and surplus implications

MR. ALAN C. CURRY: We have several gentlemen who have the opportunity to give us some remarks this afternoon. First, we will hear from James Attwood, Executive Vice President/Actuary and Chief Insurance Officer of the Equitable Life Assurance Society. He will be followed by Bob Johansen, Vice President and Actuary of the Metropolitan Life Insurance Company who has been involved with the NAIC Industry Advisory Committee on all lines charters for several years. We will then hear from Bob Pollack, Consulting Actuary from Bryn Mawr, Pennsylvania whose background is on the casualty side.

MR. JAMES A. ATTWOOD: One frequently cited advantage of the all lines charter is that there is a very significant saving by avoiding the establishment of a separate subsidiary to do the life or casualty business. This of course is based on the premise that the company wants to do several lines of business, and, further, that the company has not already incurred such expenses.

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A great many companies, including many large ones, have preferred not to wait for all lines authorization but have gone ahead to buy or establish subsidiary companies to permit the selling of a complete line of coverage. There have been numerous reasons for this including the desire to expand into additional profitable business as permitted by the New York holding company legislation of 1969, to provide an additional source of income for the agency force (in particular the debit agents whose market was shrinking) and to defend a company's group business, by positioning the group operation for the eventual enablement of true group auto and homeowners business.

For a company with the holding company and subsidiary mechanism in place, are there still significant expense savings to be gained by the adoption of an all lines charter? There are no pat answers to this question. It depends on a particular company's circumstances, which vary considerably. It seems reasonable to conclude, however, the availability of the life or casualty lines through a subsidiary would in many cases dampen the interest to pursue the all lines charter.

Another reason is the considerable appeal of the notion of "One-Stop Shopping". "One-Stop Banking" and "One-Stop Financial Services" are examples. The question is whether one-stop insurance buying from a source which is one company doing all lines of business is superior to one-stop insurance buying from a source which uses a parent and subsidiary organization.

Advocates of all lines charters rightly point to the benefits to consumers which resulted from the ability to handle fire and casualty in one company. The comprehensive homeowners' policy was a great success. Packaging various insurance products under all lines charters may analogously offer attractive possibilities for the insurance consumer.

Also, all lines charters, it can be maintained, might provide increased competition in the insurance field with a better deal for the consumer. A better deal for the consumer has to mean better service for a better price.

Some advocates see increased regulatory efficiency as one of the advantages of all lines charters, with a consequent reduction of associated expenses both on the part of government and the industry.

The advent of the all lines charter, it is also alleged, might afford companies opportunities for tax planning. The tax question, however, is exceedingly complex and technical.

Probably the greatest advantage from the all lines approach is the potential for greatly increased insurance capacity.

A major disadvantage of the all lines charter, to some observers is the disruption of the status quo. All lines charters seem to have worked well enough in Great Britain, but there are insurance people in Europe who are not taken with the idea and who wonder why we would want them here.

Another possible disadvantage, highly speculative, is that regulators might be tempted to disapprove necessary but unpopular rate increases in a casualty line, for example, automobile, and rely on life profits to shore up the casualty lines.

Insurance company taxation, claimed by some as an advantage of all lines charters, is claimed by others as a disadvantage.

The difficulties in getting all lines legislation on the books, not an inherent disadvantage of the all lines approach, is a practical disadvantage which must be considered. A couple of years ago the general counsel of one company remarked that to get fairly uniform legislation passed in 50 states required that the subject of the legislation be (1) noncontroversial and (2) necessary. He didn't think that the all lines charter question met those requirements at that time, many of us doubt that it does today.

Taxation

An NAIC industry advisory committee concluded that no change is required in the internal revenue code to accommodate all lines companies. It would be taxed as a life or non-life company depending on which side of the business had the preponderance of reserves. The committee concluded further that, on balance, neither type of company would have a clear advantage over the other upon adopting an all lines charter.

Those who see a tax advantage in the all lines approach stress the availability of greater tax planning. For example, whether to do a casualty business as part of an all lines company or through a subsidiary might be decided on the basis of the tax treatment.

It might also be possible for a casualty company with good profits to finance the start-up costs of entering the life business out of pre-tax dollars, that is, as a current deduction against pre-tax income. The cost of establishing a life subsidiary, on the other hand, would have to come from after-tax dollars.

In general, the tax effects of all lines operation will necessarily vary from company to company and will depend on profitability, mix of business and whether the company is taxed as life or non-life.

There are those who fear that any significant reduction in insurance tax revenues caused by the all lines approach will trigger new tax legislation, which could be disadvantageous to the industry.

If tax planning is an advantage of the all lines approach, this means in effect that it should be possible for some companies, by choosing or rejecting the all lines solution, to minimize or reduce their income taxes. Depending on how important the tax consideration might be in a given case, it is conceivable that this approach would afford an opportunity to select against the tax collector. And if that should happen to any considerable degree, a review of the taxation of insurance companies is bound to result.

Future Marketing Implications

A. Combination Policies When fire and casualty companies were permitted legally to combine in the 1940's, the homeowner's insurance policy was the highly successful combination which resulted. An all lines company would be in a position to improve further on this model by, for example, adding decreasing term life insurance as mortgage retirement coverage. Other combinations would doubtless be devised, probably including cash-value life insurance.

B. Agent Combination As mentioned earlier, one of the motives for some life companies to enter the casualty business was to provide an additional source of income for its agency force. This motive would continue as strong in the all lines context as in the separate company treatment.

Granted that one-stop insurance buying is a convenience for the consumer, one-stop insurance selling may be perceived as a convenience for the agent. Increased productivity of agents selling all lines to a particular customer may make it possible for agents to sell in the low and moderate income markets, markets they are largely abandoning for life insurance only sales, because of the sheer cost-benefit effectiveness involved in such selling.

C. Other If all lines charters should become available, the increased capacity which results would mostly benefit the corporate customer. There is little need for capacity to insure lives or provide accident coverage or to insure autos or homes. It is the corporate sector which probably needs increased insurance capacity to cover large, catastrophic risks. One of the challenges of the insurance industry will be to offer that capacity for sale at a price which is fair for the risk assumed.

Capacity and Surplus

As mentioned previously, the question of capacity is crucial to the all lines rationale. If the sought-after increased capacity is not created, then we should probably reject or defer the availability of all lines charters.

There are a number of ways in which capacity can be increased, including our topic of discussion — reducing the legal segmentation of the industry.

The point is made, in other words, that the shortage of insurance capacity for risks that demand high capacity is matched by an excess of capacity in personal lines with a huge spread of highly predictable risks, namely, life insurance.

It is further convincingly argued that capacity is a valuable commodity, capable of commanding a fair price. Consequently a life insurer with considerable excess capacity which is not used, or which cannot be used, is wasting a valuable commodity. The legalization of the assumption of airline reinsurance by life companies in recent years amounts to a partial recognition of this capacity availability.

Of course, there is an understandable reluctance to expose life insurance reserves to the hazards of the casualty business. This is particularly so in the case of cash-value life insurance.

The risk to which company surplus is exposed differs considerably between life and non-life insurance. Surplus may be regarded as a cushion against three major contingencies: error concerning the value of past experience; excessive current losses (combined loss and expense ratio); and loss of asset value. It can be argued that the risk to surplus from the casualty lines is greater than life in each of these contingencies.

Alternatives in combining a life with a non-life business range from an absolute combination of the lines, which produces the greatest increase in insurance capacity to complete separation which produces no real increase in capacity. In between, we can adopt some techniques for protection of the life reserves against casualty risks.

One technique is to require the all lines company to segregate the life insurance from the non-life insurance business. This obviates the need for holding companies and subsidiaries erected for the purpose of doing all lines of insurance business, with expense savings, but it does nothing for increased capacity needs.

A modification of the segregation technique is to provide a liquidation preference for the life reserves. This, in the view of some, makes the excess capacity of the life lines available for general use.

A modification of this treatment, which provides equity for all classes of insurance business upon impairment or insolvency of an all lines company, is part of the draft legislation proposed by NAIC industry advisory committee on this matter. Section 9 of draft #10 of that document reads as follows:

> "In the event of impairment or insolvency of an all lines insurer, the excess of the liabilities of any class of insurance over the accumulated assets (statement value basis) attributable to that class may be charged as necessary against the assets of any other class only to the extent that assets (statement value basis) attributable to such other class exceed the amount of reserves and other liabilities of such other class."

This is the comment which accompanies the proposed text of Section 9:

> "The asset insulation provisions of Section 9 provide for equity among all classes of insurance business of an all lines company which is impaired as defined under Section 7, or is insolvent. The legally required asset insulation between life and one or more classes of insurance effectively substitutes for the insulation between corporate entities without the overhead expense associated with multiple corporate entities. This provision also permits the total surplus funds of an all lines insurer to back up all lines of insurance thereby maximizing potential capacity."

The comments which accompany Section 7 of the draft, or maintenance of minimum capital and surplus, reinforce this opinion with respect to capacity. Thus, it is stated that "available capacity is maximized because all assets of an all lines company support all lines of insurance. . . ." and, again, "all surplus supports all lines, thereby maximizing the supply to insurance capacity available in the marketplace."

One question commonly raised in connection with the liquidation preference technique, namely, "is such a company permitted to take into account all of its assets to determine its insurance capacity?", is clearly answered in the affirmative by the drafters of this proposed model bill.

Another question that is raised in this connection is how do our segregated state guarantee funds treat this kind of liquidation. The NAIC all lines subcommittee had this to say on this subject:

> "Admittedly, this could be a problem but it does not appear to be insurmountable inasmuch as a company's contribution to each type of fund should be related to the amount of each type of business conducted by the company. In insolvency situations, each line, that is, the life lines and the fire and casualty lines, would have contributed to each guarantee fund and the guarantee fund would be responsible for payment in the event of insolvency based on claims against the guarantee associations separate account established on a line by line basis."

In conclusion, it appears that protection of the cash values of life insurance and equity among the lines, as well as the availability of excess capacity, would be achieved by this model bill. However, no one would look forward to a rash of impairments or insolvencies of all lines companies, no matter how adequate these protective devices.

MR. ROBERT J. JOHANSEN: The current version of a draft NAIC Model Act (Draft #11)*, permitting and regulating the chartering of all lines insurers, states under "findings" (Section 1) that "...existing laws with respect to the establishment and operation of insurance companies encourage or mandate a multiplicity of insurance entities which often are affiliated in complex holding company structures in order to provide various types of insurance and related financial services; and such multiplicity of corporate entities may result in a less efficient corporate form of organization, may complicate management, may restrict and impede the ability of such insurers to utilize their full insurance capacity to meet the demands of the consumer and the marketplace, may complicate aspects of regulatory control, and may retard innovative development of simplified comprehensive package policy coverages ..." The draft goes on to point out under "Purposes" (Section 3) that among other things that Act is intended "to permit simplification of corporate structure and promote corporate cost efficiencies." In the comments included under "Purposes" there is a statement that all lines authority would permit companies "to innovate and provide additional comprehensive and simplified insurance packages for the benefit of the insuring public" and "should reduce the number of corporate entities." In both cases, the draft describes these possibilities as natural extensions of the Diemand committee report which resulted in the combination of fire companies with casualty companies and the providing of packaged insurance coverages such as homeowner's policies.

The draft bill affords two and possibly three sources of financial advantages to an all lines operation. If an insurance group providing life and casualty coverages is operating through two or more affiliated insurance companies <u>solely</u> because of licensing requirements, then the statement can be made that there would be some expense saving if the separate corporate entities could be combined. This would assume that the savings would be found in a reduction of corporate and intercorporate red tape and perhaps in duplicate investment staffs. Certainly the operating staffs would be little affected

*NAIC Proceedings, December 1977

by a switch to an all lines operation — life underwriting differs from automobile and homeowners and so do the claim operations. One might also say that there would be a saving in the executive staffs of the affiliated companies but more likely these executive staffs would still exist at the vice president or department level in a single company. In other words, a saving in the number of persons might not amount to very much, depending on the organization and staffing of the respective corporate entities.

The ability to package life and casualty coverages may afford some savings and perhaps offer a selling point for the packaged policy. For example, an all lines company might sell a single contract with decreasing term life insurance and disability loss of income insurance covering a mortgage packaged with the usual homeowner's coverages. While such a specialized policy might have somewhat limited appeal, it might be a great door opener.

An all lines insurer should also find that its year-to-year earnings are favorably affected through the operations of the "Law of Large Numbers;" company with an increased spread of risk should theoretically experience smaller year-to-year variations in claims. Also, a greater variety of coverages might cause a company to be less affected by disturbances in the experience under any single coverage than otherwise. However, one may question whether a company's life insurance experience would have its swings damped by the more volatile casualty business.

The capacity of a casualty company is related to its surplus to policyholders through a rule-of-thumb measure which says that, ideally, premiums written should not exceed two to three times the amount of surplus to policyholders. The size of the maximum risk retained is also related to surplus. For example, I note that the New York Insurance Law (of Sections 47, 324 and 351) places limits on maximum size single risks at generally 10 percent of surplus to policyholders. The question of surplus and capacity will be further discussed later on, but some comments are pertinent here.

If a casualty company were to set up a subsidiary life insurance company, it would be necessary for the casualty company to provide capital and surplus sufficient to meet the minimum requirements of the states in which the life company will be admitted. It is also necessary to provide for the initial statutory losses which are expected in the early policy years from the underwriting of individual life insurance contracts. Except to the extent that the equity in the life subsidiary could be counted by the casualty company in its surplus to policyholders, it would find that its surplus was reduced by its subsidiary investment.

Roughly the same effect would occur if the casualty company were to do a life business directly -- the surplus eaten up by the high issue costs under the life coverages would still be gone. As the life business ages, it would begin paying back borrowed surplus and accumulating additional surplus which could then increase its casualty insurance capacity. The adoption of preliminary term reserves would, of course, materially improve the financial picture both initially and over a period of years after entry into the life insurance business. Income taxes may affect the picture but I would like to reserve a discussion of that aspect until later on.

If a life company wished to enter a casualty field, it would find that its surplus to policyholders would provide capacity in terms of both amount of premium written and maximum size of risk. However, the rate of growth must be controlled since the life company must be careful that early losses in casualty lines do not make substantial inroads into the surplus developed by the life lines. Other things being equal, the statutory statement of a life insurance company writing casualty coverages directly would look better than for a life insurance company with a casualty sibsidiary in one way, at least. Under present rules, a life company's Mandatory Securities Valuation Reserve (M.S.V.R.) must include the stock of a casualty subsidiary (but not that of a life subsidiary with its own M.S.V.R.). Thus increases in the equity of its casualty subsidiary stock would be absorbed in the M.S.V.R. The casualty company with a life subsidiary does not have a M.S.V.R. and consequently increases in the equity value of the life subsidiary's stock are reflected directly in the casualty company's surplus.

There could be a temporary asset drag for a life company with funds tied up in capital and surplus of a casualty subsidiary where the investment return may not be commensurate with that on other assets. The life insurance company federal income tax formula for tax on investment income also exacts a toll for low-yielding assets in the calculation of the current investment earnings rate. An all lines approach might be more advantageous.

A possible financial disadvantage could develop if a company with all lines authority was required to participate in a joint underwriting association, reinsurance pool or similar risk-sharing device for lines of business which it does not write.

I have not discussed the differences in investments held by life vs. casualty companies, how the investment portfolio might be managed in an all lines company and what the effects might be. This could well be a discussion all by itself and leaves room for considerable conjecture. However, I suggest that Mr. Paul Otteson's Discussion Note prepared for this morning's Concurrent Session D on Investment Portfolio Theory is pertinent and of considerable interest.

From the foregoing, it would appear that the financial advantages and disadvantages of an all lines mode of operation, as compared with the subsidiary route present a mixed picture. Careful study under various assumptions as to operations, product mix, gains and losses, taxes, etc., is most certainly indicated.

Let us now examine how the insolvency of an all lines company might affect the operations of the guaranty funds. At present, more than 20 states have guaranty funds for life and health insurance, and annuities, and almost all the states have casualty guaranty funds. Under the National Association of Insurance Commissioners (N.A.I.C.) life insurance guaranty association model bill, three accounts are set up for assessments in the event of an insolvency, namely, life insurance, health insurance and annuities. Under the N.A.I.C. (casualty) insurance guaranty association model bill assessments are levied under three accounts: workmen's compensation; automobile; and all other (but excluding life, title, surety, disability, credit,(i.e., accounts receivable) mortgage guaranty and ocean marine).

In the event of an insolvency of an all lines company, the losses occasioned under the various coverages should be distributed among the guaranty associations by line of business. Further, the provision in the all lines Model Act providing for the walling-off of assets of an impaired or insolvent company between the long-term business on the one hand and the short-term business on the other affords some protection against losses in the casualty side being assessed against the life insurance guaranty associations and vice versa. It also recognizes the essential difference between the short-term casualty insurance on the one hand and the cash values and continued insurability of impaired lives inherent in life insurance on the other hand.

The Model Act requires that all surplus be depleted before an all lines company can be declared insolvent. An all lines company could not "go broke in pieces" and declare that one line was insolvent while the rest of the company goes merrily on. In the event of an insolvency of an all lines company, the life insurance business probably could be sold at a profit. We would probably find that the remaining assets of the insolvent insurer, perhaps including the profit from the sale of the life business together with money from the guaranty funds, would be used to work out the casualty claims.

In several recent bills establishing guaranty associations there is a paragraph which may prove troublesome. It says "all assets of the impaired or or insolvent insurer attributable to covered policies shall be used to continue all covered policies and pay all contractual obligations of the impaired or insolvent insurer as required by this chapter. Assets attributable to covered policies, as used in this subsection, are that proportion of the assets which the reserves that should have been established for such policies bear to the reserve that should have been established for all policies of insurance written by the impaired or insolvent insurer." It seems clear that if the walling-off of assets were to be done not by fund accounting but on the basis of reserves that "should have been established," we could have a problem of equity in a case where an insolvent insurer had been maintaining grossly inadequate reserves under its casualty policies. Because of statutory definitions of life and annuity reserves, the reserve is unlikely to occur except where a company has maintained inadequate health insurance reserves.

Tax Implications

To help in following the discussion on taxes, some simple numerical examples have been prepared comparing the tax and gain after tax of casualty and life operations taxed separately as compared with the tax effects on the combined operation. The examples also show what happens if the proportion of tax-exempt securities is changed, assuming a lower rate of return on such securities.

How a company is taxed is being accorded increasing recognition by insurance companies as the interaction of the quirks of the tax law and the quirks of an insurer's operations become better understood. The tax implications of combining life and casualty lines within the same company compound the complications. I suggest that we look at three situations: an all lines company taxed as a casualty insurer; an all lines company taxed as a life insurer under Phase II; and an all lines company taxed as a life insurer under Phase I.

In order to simplify our consideration, we shall assume that the casualty company is taxed on its overall profits — that is, on its underwriting profits plus its investment income. We shall assume simplistically that the Phase II company is taxed on its life insurance company investment income plus half the excess of its gain from operations over its taxable investment income, while the Phase I company is taxed only on its life insurance company investment income.

We shall look at the casualty company first. (See Case 1 and Case 2) When the casualty company begins writing life insurance, the life insurance business will be in a loss position because of its high initial expenses and the setting up of statutory reserves. (The tax law relating to casualty companies specifies that life insurance and annuity reserves are to be treated as unearned premiums.) Consequently, the increase in life reserves will be a deductive item in computing the gain from operations. Assuming that the casualty insurer is earning profits on its casualty business, it would find that its current taxable income was reduced by statutory losses on its life business. In later years, as the life business grows and matures, emerging profits will increase the taxable income of the company as the new business costs are repaid and gains from underwriting and from investment income arise. (A casualty insurer can take full advantage of investments in tax exempt securities - whereas a life insurance company cannot do so.) If its life insurance business grows to such size that the life reserves exceed those of the nonlife business, then, of course, the casualty insurer will find itself taxed as a life insurance company. Nevertheless, there appears to be some tax advantage for a casualty company to operate as an all lines company rather than have a life affiliate, at least initially. There is also the possibility of a competitive advantage to such a company in issuing contracts with a high interest component such as nonqualified deferred annuities at attractive interest rates. In our examples, Case 1 favors the affiliate approach, Case 2 the all lines.

Suppose we have a company as a life insurance company under Phase II. (See Case 3) Such a company is taxed on its life insurance company taxable investment income (after allowance for investment income allocated to reserves) plus half of the excess of its gain from operations over its taxable investment income. If such a company were to do a casualty business while remaining a life insurance company under the reserve test, any underwriting gains from the casualty lines would be added to its life underwriting gains, while any underwriting losses would be subtracted from life gains. This would appear to give some early advantage to an all lines approach as opposed to an affiliate approach for a Phase II insurance company entering a casualty field such as auto, where early year losses are expected. A life company under Phase II could find itself at a disadvantage where competitive pressures cause casualty premiums to fall short of claims and expenses with the expectation that losses will be more than offset by investment income. Our example indicated little difference between the affiliate approach and the all lines approach.

The last case is an all lines company taxed as a life insurance company under Phase I. (See Case 4) Its casualty underwriting gains would not be taxed, but casualty underwriting losses could not be used to reduce taxes currently nor carried forward or backward, an apparent advantage or disadvantage, depending on the gain or loss situation. On the other hand, as the investment income on its casualty funds such as unearned premium reserves and claim reserves grows, it would be taxed at the full corporate rate regardless of the casualty underwriting gain or loss position. Again, the company cannot derive full tax advantage from increasing the proportion of its tax-exempt investments. Whether or not the casualty lines are such as to develop sizable claim reserves would have an important bearing on the financial effects of such an all lines operation. Our example indicates a slight edge to the all lines approach. But note what happens if the proportion of tax-exempt investments is increased.

One further word of caution is required. For a stock company taxed as a life insurance company under Phase II, failure of the reserve test for two consecutive years could be a disaster. This is because the full amount in its policyholders surplus account is taxed at the corporate rate as of the end of the tax year preceding the first year in which it fails the test.

I hope that these brief remarks will generate further thought and discussion.

CASE 1
FEDERAL INCOME TAX EFFECTS
ALL-LINES INSURER TAXED AS CASUALTY INSURER
(LIFE BUSINESS - PHASE II)

($ Thousands)

	Casualty Operations Taxed as Separate Casualty Company (1)	Life Operations Taxed as Separate Phase II Life Company (2)	Combined Operation Taxed as Casualty Company (3)	Same as (3) but with Increased Tax Exempt Income (4)
Assets Jan. 1	1,500	550	2,050	2,050
Assets Dec. 31	1,700	600	2,300	2,300
Life Ins. Reserves Jan. 1		460	460	460
Life Ins. Reserves Dec. 31		480	480	480
5-Year Average Int. Rate (Life)		6.6%		
Average Val. Int. Rate (Life)		3.0%		
Premiums Earned	1,000	100	1,100	1,100
Net Investment Income	70	40	110	100
Net Investment Income (exempt from tax)	40	----	40	55
Claims and Expenses	980	90	1,070	1,070
Increase in Life Reserves	----	20	20	20
Underwriting Gain	20	NA	10	10
Gain from Operation before F.I.T.	90	30	120	110
F.I.T. @ 48%	24.000	12.035	38.400	26.400
Tax Deferred on Addition to Policyholders Surplus Acct.				
Gain after F.I.T.	66.000	17.965	81.600	83.600

(Σ (1) + (2) = 83.965)

CASE 2
FEDERAL INCOME TAX EFFECTS
ALL-LINES INSURER TAXED AS CASUALTY INSURER
(LIFE BUSINESS - PHASE I)

($ Thousands)

	Casualty Operations Taxed as Separate Casualty Company (1)	Life Operations Taxed as Separate Phase I Life Company (2)	Combined Operation Taxed as Casualty Company (3)	Same as (3) but with Increased Tax Exempt Income (4)
Assets Jan. 1	1,500	550	2,050	2,050
Assets Dec. 31	1,700	600	2,300	2,300
Life Ins. Reserves Jan. 1	——	450	450	450
Life Ins. Reserves Dec. 31	——	480	480	480
5-Year Average Int. Rate (Life)		6.6%		
Average Val. Int. Rate (Life)		3.0%		
Premiums Earned	1,000	100	1,100	1,100
Net Investment Income	70	40	110	100
Net Investment Income (exempt from tax)	40	——	40	55
Claims and Expenses	980	95	1,075	1,075
Increase in Life Reserves	——	30	30	30
Underwriting Gain	20	NA	-5	-5
Gain from Operation before F.I.T.	90	15	105	95
F.I.T. @ 48%	24.000	9.772	31.200	19.200
Gain after F.I.T.	66.000	5.228	73.800	75.800

(Σ (1) + (2) = 71.228)

CASE 3

FEDERAL INCOME TAX EFFECTS

ALL-LINES INSURER TAXED AS LIFE INSURER

(LIFE BUSINESS - PHASE II)

($ Thousands)

	Casualty Operations Taxed as Separate Casualty Company	Life Operations Taxed as Separate Phase II Life Company	Combined Operation Taxed as Phase II Life Company	Same as (3) but with Casualty Underwriting Loss = 2
	(1)	(2)	(3)	(4)
Assets Jan. 1	150	550	700	700
Assets Dec. 31	170	600	770	770
Life Ins. Reserves Jan. 1		460	460	460
Life Ins. Reserves Dec. 31		480	480	480
5-Year Average Int. Rate (Life)		6.6%	6.1%	
Average Val. Int. Rate (Life)		3.0%	3.0%	
Premiums Earned	100	100	200	200
Net Investment Income	7	40	47	47
Net Investment Income (exempt from tax)	4	——	4	4
Claims and Expenses	98	90	188	192
Increase in Life Reserves	——	20	20	20
Underwriting Gain	2	NA	NA	NA
Gain from Operation before F.I.T.	9	30	39	35
F.I.T. @ 48%	2.400	12.035	14.664	13.704
Tax Deferred on Addition to Policyholders Surplus Acct.		2.365	2.712	1.752
Gain after F.I.T.	6.600	17.965	24.336	21.296
			$(\Sigma\ (1) + (2) = 24.565)$	$(\Sigma\ (1) + (2) = 22.485)$

CASE 4

FEDERAL INCOME TAX EFFECTS
ALL-LINES INSURER TAXED AS LIFE INSURER
(LIFE BUSINESS - PHASE I)

($ Thousands)

	Casualty Operations Taxed as Separate Casualty Company	Life Operations Taxed as Separate Phase I Life Company	Combined Operation Taxed as Phase I Life Company	Same as (3) but with Increased Tax Exempt Income
	(1)	(2)	(3)	(4)
Assets Jan. 1	150	550	700	700
Assets Dec. 31	170	600	770	770
Life Ins. Reserves Jan. 1	----	450	450	450
Life Ins. Reserves Dec. 31	----	480	480	480
5-Year Average Int. Rate (Life)		6.6%	6.1%	4.5%
Average Val. Int. Rate (Life)		3.0%	3.0%	3.0%
Premiums Earned	100	100	200	200
Net Investment Income	7	40	47	35
Net Investment Income (exempt from tax)	4	----	4	24
Claims and Expenses	98	95	193	193
Increase in Life Reserves	----	30	30	30
Underwriting Gain	2	NA	NA	NA
Gain from Operation before F.I.T.	9	15	24	12
F.I.T. @ 48%	2.400	9.772	12.045	2.597
Gain after F.I.T.	6.600	5.228	11.955	9.403

(Σ (1) + (2) = 11.828)

MR. ROBERT POLLACK: In light of recent development, it would be easy to view the market implications of this subject too narrowly. Much attention is being devoted to the introduction of casualty products by several major life companies, notably Prudential, Equitable, Metropolitan and John Hancock. But the complete intersection of the life and casualty segments of our industry encompasses all types of company and marketing systems. These four life companies have moved into the individual risk personal lines casualty business sold through captive agents. Obviously, this is an important new thrust. But we should not lose sight of the other areas in which life and casualty insurance now intersect. For example, many casualty companies now pursue group life insurance as aggressively as they seek such commercial lines as workmen's compensation, liability and fire. Organizations that had been predominantly personal lines casualty are now major factors in the ordinary life field. Direct-to-consumer life and health companies have started casualty subsidiaries.

Unfortunately, in the few minutes we have today, it would be impossible to discuss all these different marketing systems, so I'll confine my remarks largely to the intersection in the personal lines area.

We have seen the most dramatic evidence of the industry intersection in the last five or ten years. Between 1966 and 1976 INA moved from 78th to 26th place in life insurance premium. Similarly, State Farm had moved from 47th to 29th. Other dramatic changes in rank were made by Allstate, Hartford, Kemper, Nationwide and Safeco.

The progress by the aforementioned major life companies has been even more dramatic. By the end of 1976 Prudential was the 31st largest casualty company and Metropolitan, Equitable and John Hancock had cracked, or were about to crack the top 100, even though none of them were in the casualty business as recently as 1971.

Why are we moving so rapidly toward becoming a single industry? Principally because it is logical. The consumer doesn't make the distincition that the industry does between life and casualty insurance. Opinion surveys have constantly shown that the public would like to handle its insurance through a single source. Their buying patterns currently belie these surveys, but I suspect that the public has moved more slowly toward "one stop shopping" than they would prefer, largely because the industry hasn't made it convenient. As the parts of our industry draw closer together, so too will the public's buying preferences and buying habits.

In the long run, a customer has the right to assume that he should get better service at a lower price by purchasing all of his insurance through a single source. Unfortunately, the industry is a long way from fulfilling these expectations. Though many organizations now have the capacity to now sell a full line of products, they tend to service them as separate businesses. These same systems tend to minimize potential cost savings. If we were organized on a true multi-line basis, the administrative cost of handling several coverages aggregating $2,000 in annual premium should not be 10 times as costly as handling a single coverage with a $200 ticket. In addition, it is cheaper for an agent or company to add coverages to an existing insured than to prospect for brand new customers. Thus, acquisition costs should be lower for volume purchasers.

There are many other cogent reasons for the evolving intersection. For example, it makes sense for an organization seeking to diversify to expand into businesses reasonably related to what it already does. An insurance company is more likely to succeed selling other forms of insurance than manufacturing widgets. Another significant consideration is that a company's agents are more likely to succeed with additional products in their portfolio. The Life Insurance Marketing and Research Association estimates that only 19% of newly hired life agents remain after two years. Selling life insurance is difficult. Potential customers can invariably find an excuse to defer the purchase of life insurance irrespective of need. On the other hand auto and homeowners insurance are virtual necessities. The life company agent with casualty products has a distinct advantage, and the company he works for is similarly advantaged. Prudential's average agent turnover rate was 50% in 1972—approximately equal to the life industry's average. In 1977, their rate was down to 35%. Further improvement is possible, particularly when we consider that the average Prudential salesman today earns less than half as much as his State Farm counterpart. Prudential's increasing emphasis on casualty lines should dramatically change that relationship in the future.

One of the major reasons for the life companies diversifying into property and casualty is the steady shift away from ordinary life insurance toward alternative savings vehicles. Premiums per thousand have been steadily dropping as a result of such considerations as improved mortality, the changing mix between whole life and term, and in roads of group insurance, lower birth rates and higher divorce rates. As a result, the real income of life agents has been declining. And distribution costs are rising with inflation, especially the costs associated with training and developing agents. Experience suggests that it is easier for life companies to sell casualty insurance than to produce profits from their casualty business. The casualty business is subject to inflationary pressure, business cycles, and excessive regulation. The results of 1975 and 1976, when many large respected casualty companies came perilously close to the brink, indicate the difficulty in making money in casualty insurance, especially in personal lines. The new life company entrants into the casualty business have discovered this problem. But it has been argued that life companies can live with relatively bad operating results. For example, the President of Metropolitan Property and Liability Insurance Company has stated that "if, in returning 6% on casualty operations, we should increase our agents' earnings by 50% and reduce turnover by 30% or more, we would increase bottom line for the parent line tremendously".

Even if we accept this argument, there are no guarantees that life companies can achieve even this modest level of casualty profit. To realize even modest underwriting results, the life companies will have to cope well with the many underwriting pitfalls in the casualty business.

Anyone who has read a casualty trade journal in the last couple of years is aware of the hew and cry for new buzz words—availability and affordability. This has been combined with an increase in the decibel level surrounding the question of discrimination, fair or not. It is not difficult to project a future in which underwriting and pricing decisions will be severly constrained by laws designed to minimize risk distinctions, regardless of actuarial indications. As examples, industry experience shows that place of residence, age and past accident record are important determinants of probable future claim cost. Any pricing or underwriting restrictions could produce devastating results for a company selling to the wrong end of the risk spectrum.

The erosion of insurer freedom has already begun. In Massachusetts and North Carolina, for example, class and territory distinction have been sharply curtailed. And in the premier example of social engineering in casualty insurance the private insurance industry must provide Hawaiian welfare recipient with free automobile insurance.

Pricing and underwriting freedom still exists to a reasonable degree in most states. But there are imperfections in the casualty pricing systems that could create major difficulties for a new company. As an example, most companies' classification plans assume a great deal of uniformity in auto insurance among people between the ages of 30 and 64. There is statistical evidence that this assumption is invalid. A life company selling auto insurance to its 35 year old life policyholders is unlikely to produce the same results as a company selling to people in their 40's and 50's and 60's. Similarly, current geographic risk grouping often homogenizes large heterogeneous areas into single rating territories. Many other demographic characteristics—e.g. income, education, size of family, etc. — are largely ignored by the current casualty pricing systems but probably impact on underwriting results.

In summary, the life company entering the casualty field faces a host of problems that are unique to the casualty business.

As for the other side of this coin, many casualty companies have had life running mates for years. State Farm has been in the life insurance business since 1929, Nationwide since 1935 and Allstate since 1957. But sales growth was relatively slow until recently partly because agents familiar with casualty insurance had little incentive to tackle the tougher life insurance sale. In recent years this attitude has changed markedly. Nationwide now devotes 30% of total training time to life insurance in contrast to 10% a decade ago. Life insurance now accounts for 25% of State Farm's advertising budget whereas it was less than 10% five years ago. Allstate has recently increased their life sales' goals substantially. In part, these companies are reacting to the realization that, unless they become more aggressive multi-line companies, the major life companies will make in-roads into their auto and homeowners business.

Another reason for the movement of casualty companies into life insurance is the relatively predictable earnings in that business. An interesting clue to the relative stability of the two components is a comparison of the price earnings return of stock, life and casualty companies. Currently, casualty companies are selling for PE's not much more than half as large as life companies

In summary, the intersection of life and casualty operations is a natural evolution offering both insureds and insurers important advantages. It is really not critical that a company diversifying into other insurance lines invent anything new or novel. It is more important to make the most efficient possible use of the valuable time of company personnel and sales representatives. In short, the object should and will be for a company to capitalize on its in-place sales, marketing and service organization to achieve diversification of insurance products.

MR. CURRY: One comment on a statement of Jim Attwood's — which was "if there is a lack of capacity in the casualty field at this time it is probably with the large corporate customer" — I would certainly agree, but that may change a bit, Jim. In fact, for any of the life actuaries in the room who have not already done so, I would like to suggest that you get a firm grip on your surplus and come on over to the casualty side, because I am not sure that I can see where we are going to get the necessary capacity for all the business looking for a home. Really, it is kind of fun. Several years ago the leader of our life operation said he didn't expect to live long enough to become aware of the mistakes he made in the business — we don't have that problem on the casualty side. In fact, Bill Gillam just made some comments a few minutes ago about, ". . . if you don't find mistakes via the monthly statement, there are all kinds of people standing around the sidelines waiting for the chance to tell you what you're doing wrong", and if we just repeat the 48% increase in the number of automobiles on the road in the last ten year period, plus a 6% inflation rate — which most people concede will exist — and you compound this for ten years, you are looking at increases that are just astronomical, in terms of what automobile insurers must take to surplus these days. Maybe some of the non-auto lines aren't going to increase that fast, but Workmen's Compensation doesn't look a whole lot better, and medical malpractice doesn't look a whole lot better, and coverage for hospitals doesn't look much better, so I'd just like to encourage all of you to bring all your money over here to the casualty side.

MR. C. K. KHURY: I have a question for Mr. Attwood. You spoke about added capacity. Consider, if you will, a life insurance company going into the property and casualty insurance business. I wonder if you can comment on the source of this added capacity. Is it through investment of the life insurer's surplus or through investment of the life insurer's policy reserves?

MR. ATTWOOD: It comes through the investment of life insurer's surplus.

MR. KHURY: Let me pursue the question. Normally a life insurance company has its surplus invested and producing some rate of return. If you identify the source of surplus in the property and casualty company as being an investment of the surplus of the life insurer, isn't that akin to overworking the same surplus dollar?

MR. ATTWOOD: If it is profitable use of that surplus, it is a double use of the surplus dollar. You can earn investment income and can also hopefully earn insurance income.

MR. KHURY: Does that imply greater risk?

MR. ATTWOOD: Yes.

MR. KHURY: I wonder if you would compare this to providing added capacity through invested policyholder reserves?

MR. JOHANSEN: You would not invest your life insurance reserves in a subsidiary. In fact there are laws which limit the amount that can be put into a subsidiary — those limits are in terms of surplus. There are limits not only on the total amount of surplus which can be put into one insurance subsidiary, but also on the total amount of surplus that can be put into all insurance subsidiaries. An insurance company with an insurance sibsidiary is in effect using its surplus twice. However, relying on the Law of Large Numbers, if the spread of risk is increased, perhaps the chance that any substantial part of that surplus will be used for abnormal variations in experience will be reduced.

MR. KHURY: May I say that the concensus of the two gentlemen is that the source of added capacity is additional utilization of life insurance surplus?

MR. JOHANSEN: Yes. In particular, for a mutual life insurance company there is no other source of funds.

MR. ATTWOOD: I want to comment on a couple of things that were stated, if I could. One is the possibility of duplicate investment staffs. We have avoided this by having only one investment staff in the parent life insurers, and we sub-contract that investment staff to the property/casualty subsidiary at an arm's length transaction. We have a problem when we end up with different results in the two places and we try to explain the results with the same staff doing roughly the same type of business. On the other hand, we do have duplicate administrative and claim staffs, although we have this even within the life business. As probably most of you know, the group business is often done differently than the ordinary business and, even within the group business there is a separate staff doing the pension business versus doing the life and health business etc. An oft-cited advantage of doing both life and casualty business is the possibility of combining claim staffs. Yet, those companies that have been in the business a lot longer on a multiple line basis have generally shied away from such combinations. Many have separate group, individual and property/casualty claims and administrative staffs, so I am not sure whether there is really much to be gained through the combination of administrative and claim staffs.

MR. JOHN C. MAYNARD: I have a question for Mr. Pollack. At one point you were comparing the two situations where a casualty company decides to enter the life business and, on the other hand, where the life company decides to enter the casualty business. I think you implied that it was easier for the casualty company to enter the life business than the other way around, for the reason that the life business was a little bit more stable with regard to underwriting, classifications, and general operations than the casualty business, which is so dependent on regional underwriting, classifications systems, and experiences which vary in a heterogeneous way across the country. This would make it easier for a casualty company (which presumably has those problems under control) to go into the life business and operate it fairly widely as opposed to a life company which might enter the casualty business and find it difficult to deal with all these regional classifications and heterogeneous experiences. Have I understood you correctly?

MR. POLLACK: Yes, you did, and I think the experience of the two segments of the industry has clearly shown that the return on investment in the life insurance business has been, by and large, substantially better than that of the property/casualty business for a long time. There is also another factor that I did not do any more than lightly touch upon, that is probably the framework within which all these casualty problems exist, and that is the fact that the casualty business is very heavily regulated including the regulation of prices and in some cases even underwriting decisions.