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THE FUTURE REGULATORY ENVIRONMENT OF LIFE AND HEALTH INSURANCE

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o An exploration of likely future scenarios, to encompass:
  - Balance between state and federal regulation
  - Effects of trends in tax regulation
  - Implications of all-federal or all-state regulation

MR. PAUL JANUS: The subject matter for this session is about as all-inclusive as one could imagine. The current state of regulation is extremely cloudy, without trying to figure out what the future state of the regulatory environment is going to be, particularly the tax environment. Our panelists will try to blow away some of that haze and smoke.

Our first speaker is Arthur C. Schneider. Mr. Schneider was recently named Partner at Peat, Marwick, Mitchell and Company. He has spent approximately ten

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years in the accounting profession. His expertise has been in the insurance industry and with tax matters. He has a Master of Science from DePaul University, and he will speak about the current tax situation and what that may portend for the future of the industry.

MR. ARTHUR C. SCHNEIDER: From a tax standpoint, I think we have to say that the future is now. As you know, the House of Representatives last year passed a major tax reform bill. Even as we sit here, the Senate is deliberating its version of the tax reform bill. I think it's clear that we are going to get a major tax reform bill sometime this year, probably within the next two or three months. This bill would have many sweeping changes that would affect the economy as a whole and, in some cases, the life insurance industry and its products specifically.

I will talk about some of those broad policy changes, but first I'd like to note a few of the specific changes that would apply to life insurance companies and to their policyholders. Life insurance companies just went through a major tax reform revision in 1984, so the current proposed changes in the tax reform bill do not substantially change the life insurance company tax formula.

The most apparent change is the elimination of the 20% special deduction that life insurance companies were entitled to take in arriving at their taxable income. When this provision was put in in 1984, many life insurance companies thought that it would be an easy target for elimination. It has proved to be that, as both the House and the Senate bills would repeal it effective January 1, presumably January 1 of next year. However, even though it is being repealed, it doesn't really involve a tax rate increase for life insurance companies, because the general corporate tax rates would be lowered to either 33% or 35%, depending on which version of the bill eventually gets enacted. As life insurance companies now are subject to an effective tax rate of 36.8%, they would have a cut in their tax rate. However, compared to other financial institutions or other corporations in general, this would remove a tax advantage that life insurance companies did enjoy.

On the other hand, the special 60% deduction for small life insurance companies would be retained. Their maximum tax rate under the tax reform bill on the

first $3 million of taxable income would be approximately 13% (for companies that have less than $0.5 billion in assets).

A problem has arisen with respect to enactment of the repeal of the 20% deduction and the cut in the corporate tax rate, in that the repeal would be effective at the beginning of 1987. However, the tax rate cut would not be enacted until July 1 of next year. This means that life insurance companies would have an average effective tax rate for 1987 of 39.5%, half way between 33% and 46%, as compared to the 36.8% they currently have. However, it is expected that that problem would be worked out before the final version of the bill is passed.

A somewhat less publicized change, but an important one for life insurance companies that write cancellable accident and health products, relates to the discounting of unpaid loss reserves. The Senate Finance Committee tax reform proposals would require property and casualty insurers in general to discount their unpaid loss reserves on all types of business, including cancellable A&H business issued by property and casualty insurers. Those rules applying to cancellable A&H products also would apply to companies that are taxed as life insurance companies. The property and casualty discounting rules in general would prescribe an interest rate and a loss payment pattern. These would be applied to various lines of business to arrive at discounted loss reserves to be deducted for tax purposes. For cancellable A&H business, there are three different rules that apply, depending on what type of business is subjected to the discounting. This would apply to unpaid loss reserves on both Exhibits 9 and 11 of the life company annual statement.

For disability insurance other than credit disability, the tax reserve computation would be done in a manner similar to that used for non-cancellable A&H products under the life insurance reserve valuation rules. However, companies could, in computing the discounted reserves for cancellable disability products, use their own experience for mortality and morbidity. The interest rate that they would use would be the prevailing interest rate in 26 states in the year in which the accident occurred as compared to the year in which the policy was issued. Also, a statutory reserve limitation on the amount of deductible

tax reserves would be imposed on an aggregate basis, as compared to a contract by contract basis that generally applies for non-cancellable products.

Medical reimbursement types of coverages would be subject to the general discounting rules that apply to property and casualty companies. This means that for 1987, a 5% discount rate would apply. Going forward, a rate would be set based on 75% of what is called the applicable federal rate. This is a rate that is published by the Treasury and is used for other non-tax purposes. That rate is currently around 7.5%. In determining the period for which the discounting would be done for medical reimbursement, all unpaid losses at the end of an accident year would be assumed to be paid on July 1 of the following year.

There are also rules relating specifically to credit disability policies. These would be treated like short-tail lines of business for property and casualty insurers. This means that the discount period for that type of product would generally be over a four year period.

The effective date for these changes would be January 1 of next year. There would be a fresh start allowed for the difference between the undiscounted ending 1986 loss reserves and the beginning 1987 discounted loss reserves. This means that the difference would be forgiven and never have to be brought into taxable income.

One other point on these types of products is that property and casualty insurers would also be subject to a separate rule requiring them to deduct only 80% of their increase in unearned premium reserve on these types of products. While life insurers are subject to the same discounting rules for unpaid losses as property and casualty insurers, they would not have the same rules for unearned premium reserve. A life insurance company would not have to reduce its unearned premium reserve on this type of product for tax purposes.

The tax bill also includes several provisions that affect policyholders of life insurance companies. Under current law, when a death benefit is paid to a surviving spouse under an installment payment option, $1,000 of annual interest is excludable from taxable income on the surviving spouse. The tax bill would

repeal that exclusion. It would also require that the amount of the payments excluded from taxable income and considered a return of the investment in the contract would be based on gender-neutral mortality tables that would be prescribed by the IRS.

Another change in the taxation of products would be, for the corporate owner of a deferred annuity, a current tax on the income build-up of a deferred annuity. This would apply to what are called non-natural persons, which would generally be any entity other than an individual. The intent of this provision is basically to restrict the use of deferred annuities to fund non-qualified deferred compensation plans.

There also would be a change with respect to early withdrawal penalties from deferred annuities as they apply to individuals. Under current law, a 5% penalty applies to withdrawals before age 59-1/2. However, that penalty does not apply if the withdrawal is taken in substantially equal payments over at least a five year period, or if it relates to investments that were made before August 14, 1982. The proposed tax reform bill would apply the 5% early withdrawal penalty to any withdrawal before age 59-1/2 unless it was taken in the form of a life annuity, and it would also apply to all investments, whether or not made before August 14, 1982.

The tax reform bill would also repeal the deduction for consumer interest. In a life insurance company's context, this could affect the deductibility of policy loan interest from the policyholder tax standpoint. It also may affect the ability of companies to market minimum deposit type plans that utilize borrowing from the cash values for premium payments.

Here are a few general observations about the tax reform bill in a broad sense. First of all, despite the Treasury Department's urging, the House and the Senate bills changed neither the tax treatment of workers compensation payments nor health insurance. The bills seem to discourage some forms of long term investment. For example, I'm sure you're all aware that they eliminate the deduction for IRAs on individuals who are active participants in an employer maintained retirement plan. They also substantially reduce the contributions that can be made to 401K cash or deferred type arrangements to

$7,000 on an annual basis. They further tighten the contribution limits that apply to defined contribution and defined benefit qualified retirement plans.

On the other hand, the cut in the individual tax rates and the disallowance of deductions for consumer interest are meant to stimulate growth, reduce consumption, and give taxpayers more incentives to increase savings, hopefully improving the economy as time goes on. By eliminating the tax benefits of many currently allowed types of tax shelters, the effect may be that old standby tax shelters, such as municipal bonds and life insurance, could be significantly affected. They could enjoy a significant influx of cash as people are looking for ways to still get tax deferrable benefits out of existing types of tax shelters.

Projecting further into the future, beyond the current tax bill, is a little more difficult to do. I would not be surprised to see proposals in the future again relating to the taxation of insurance products to policyholders. Once the Treasury puts an idea into play, it is very reluctant to drop that idea when future revenue sources are needed. A good example of that is that even after being defeated in the House of Representatives on its proposals to tax the inside cash value buildup of life insurance and deferred annuity products, the Treasury came back to the Senate Finance Committee with similar proposals. These proposals were to treat policy loans as taxable distributions from cash value insurance products, and also to place some kind of annual or total limit on the amount that individuals could contribute to deferred annuities. So I think when the time comes to consider additional revenue-raising ideas, it is very likely that the Treasury Department will quote proposals along the lines of those proposed but defeated in this current round of tax legislation.

Lastly is just a comment or two about the status of Treasury regulations to be issued regarding current law, particularly with regard to the 1984 tax law changes. The Treasury, on the tax code in general, has at the current time over 400 regulation projects open. Unfortunately only a couple of those relate to the 1984 life insurance company tax changes. In the area where the most guidance is needed, the revaluation of life insurance reserves, it only has one project open. This is on a relatively minor point of prescribing mortality tables when there are no prevailing commissioners' standard tables.

If the tax reform bill passes, which seems very likely, the Treasury Department is going to be swamped with the need to provide immediate guidance on the provisions that will be enacted under that bill. It seems very unlikely that there will be any regulations issued in the near future that provide significant guidance to the industry on the 1984 tax law changes. I think part of that may be intentional. So I would not expect to see much guidance at all from the Treasury Department on the 1984 tax law changes in the near future.

MR. JANUS: This is the fourth tax bill for the insurance industry in the last half a dozen years. I don't know how we can manage our own tax planning, much less try to guess what we're going to do two years in the future. We don't have all the regulations on the current bills yet.

The next speaker has a very different background than Mr. Schneider. Mr. Jeffrey Prussin is a political philosopher and health systems expert. He is currently president of Health Systems Development Corporation, a consulting firm. After receiving an M.S. at Johns Hopkins University, he began his career at Kaiser Permanente as Assistant Director of Research. He went on from there to be Director of Education and Training at the Health Systems Association. He served as a Manager of Program Development for Health Systems at Westinghouse and then served as an independent consultant for nine years, working largely with the federal government. He helped to draft the original Health Maintenance Organization (HMO) legislation. He helped draft some of the legislation affecting the Medigap policies and is currently working with Representative Claude Pepper and others on some of the catastrophic proposals. Mr. Prussin was recently Senior Vice President of Government Relations for International Medical Centers. Prior to that he was an Executive Vice President of CAC, another HMO in Florida. He was very instrumental in developing the Medicare risk demonstration projects. Mr. Prussin will speak on the status of health care legislation and regulation and what he sees in the future for that.

MR. JEFFREY A. PRUSSIN: I'd like to discuss the reasons for interest on the part of the government in health care, to put things in perspective. Then I'll briefly discuss some of the ways in which the government can be involved, at least in theory and in fact in practice. Finally, we will look to the future

and discuss some of the programs that may be pending and may or may not go anyplace.

First of all, why is the government so interested in health? At this point in time, it's not only the government; it's corporate America, individuals and just about everyone.

The primary reason, of course, is health costs. They've gotten out of hand, or so we feel. Let me give you a couple of examples. The first year of the Medicare program, costs were projected to be $1.5 billion. The actual costs of the first year of the program were $3.6 billion. In 1965, Medicare costs for 1990 were projected to be $8.8 billion. As you know, we've exceeded that by a multiple of almost ten-fold, and by 1990 I'm sure we will exceed it by more than ten-fold.

Here are a couple of examples in the private sector. In 1984 Chrysler paid $550 per car in health benefits, or had to produce 70,000 cars to pay for its health benefits. During the same year, General Motors spent $6.3 million a day on health care for its workers, or $4,600 per year per active worker on health care. In the United States, we spend approximately $1 billion a day on health care, which is $40 million an hour or $12,000 a second on health care. That is certainly enough to catch one's attention.

There are other reasons, though, for interest in health care. One is gaps in coverage. Long term care is notable. Preventive health services and catastrophic cases are other examples.

Availability of services is a third reason for interest in health care. That is, are services available in an area? Coverage may provided, but the individuals who have that coverage may not be able to get the services because the resources aren't there. Nursing facility care is a case in point where we have, in many areas, a dire shortage.

Accessibility is another issue. If services are available in the area, are they accessible? Can you get an ophthalmologist at 3:00 in the morning if you need one? Are the services that are generally available in the area accessible

to all segments of the population? Can Medicaid recipients, for example, find physicians and hospitals that will accept them as patients and treat them?

Finally, we have concerns about the quality of care. There's no question that in the United States the quality of care is generally excellent on the one hand, but it is also variable and virtually unregulated, particularly on the outpatient side.

With these concerns -- that is, costs, gaps and coverage accessibility, availability and quality -- the government finds itself in a position of knowing its problems and not quite knowing what to do about them. We know that more problems are coming down the road as technology increases. For example, we know that the cost problem will be exacerbated. We'll have to make more and more decisions as to what services are covered and for whom, and who will receive which services. Yet we don't quite know how to address these problems.

How can the government address these issues, and in what capacities? First of all, we have the government as an insurer. For example, we have Medicare, Medicaid, the Civilian Health and Medical Program of the Uniform Services (CHAMPUS), and so forth.

We have the government as a regulator as well. Examples might include mandated benefits under group health policies, as well as indirect regulation. That is, if you want to participate in a certain program, here are the rules of the game, which in turn are highly regulatory. I'll talk about another example, the voucher system, momentarily. This may, in fact, become a reality. The government will be funnelling billions of dollars to the private sector under that program. It would be very hard not to participate, so if you participate, you buy the regulation that goes with the participation.

The government can also act as a financial subsidizer. Again, under various programs such as Medicaid and Medicare, the government does provide financial subsidies to the beneficiaries of the program.

Finally, the government can act as a fiscal conduit. That is, the government can collect money and then turn around and pay it back out to other people who will take the risk, under the voucher program.

The government currently seems to be somewhat schizophrenic and somewhat at odds with itself. We're talking about, for example, under the Medicare program or the CHAMPUS program, getting the government out of the risk business, out of the insurance business. We are talking about doing this under Medicaid as well: on the one hand, shifting the burden to the private sector through a voucher program, through contracting. On the other hand, Secretary Bowen, for example, is proposing in essence a Part C of Medicare that would be a government operated program. So we really don't know which way the government might go, and I don't think the government knows which way it will go.

A couple of things are clear, though. The government activity and the private sector interest in health have stimulated certain reactions in the private sector. Managed delivery systems is one. I don't think there's any question that we will see the growth of managed delivery systems -- the growth of what's been termed supermeds, vertical integration in health. This will have a very significant impact on insurance companies. Traditional health insurance as we know it today probably will not last long in this world. The positive side of that is going to be when the shake-out is complete, if it's ever completed. Then the insurers are probably going to be the ones who end up with a central role in these managed delivery systems, the supermeds.

What are some of the government programs that are moving in this direction? First of all, let's look at Medicare. The voucher program may very well become a reality. If it does become a reality, health insurers will have to participate in that line of business. The volume would be too great, and it would give participants too great an edge over non-participants. We could project, based upon historic performance of the government, that should there be a voucher program, it's going to create some interesting problems. All of a sudden the government will be able to shift the burden of the two-tier system of medicine to the private sector, mandate coverage and dump it in the private sector's laps to worry about how to pay for it with limited resources. Indeed, if we have a voucher system, I suggest that you add a word to your vocabulary

in big letters, and that word is RATCHET, or two words, RATCHET DOWN, as that is invariably what would happen to the rates. If the government can pay 100%, why not 95%? If the government can pay 95%, why not 90%? That might be a very interesting problem for the private sector in the future and might be a mixed blessing.

I think we'll also, under Medicare, see a shifting of the burden to employers and to beneficiaries to some degree. We're already seeing the shifting to the employers, making employer plans primary to Medicare. The age limit has just been removed, so where employer plans were primary until age 70, they're now primary without an age limit.

There's talk of increased cost sharing for beneficiaries as well. The government is also looking at a number of demonstration projects that would be predecessors of the voucher program. Despite the fact that the Maryland proposal had some problems, the government is still very interested in the intermediary at risk concept. The significance of that for insurers is tremendous. You are talking about taking all the Medicare beneficiaries in a state and giving the money for those beneficiaries to one organization. This creates tremendous volume and gives that organization inordinate access to those beneficiaries, to that large population group; it also gives the organization that income with which to subsidize other lines of business and gain market advantage.

There are a number of legislators proposing a Part C of Medicare. If I were to bet on it, I would guess that isn't going to happen in the foreseeable future. There's still too bad a taste from, for example, the End Stage Renal Disease (ESRD) program and the cost of that program.

Catastrophic coverage and medical IRAs, long term care, is a hot field. I think there's an opportunity for the private industry to preempt the government. I know there are a number of new products that are out, particularly in long term care, and products that are on the drawing board. Mr. Janus' company has some very interesting products that he has discussed with me. But I think it's going to be a race. I think if the private industry doesn't do something in those areas fairly soon, you'll find the government is doing it. The

government will then perhaps turn it back to the private industry, but in a very regulated manner -- more regulated than it would be if the private industry did it on its own.

Finally, at least over the next couple of years, there is a key word in health care, in addition to the word "ratchet," and that word is competition. I think that the government is going to view favorably virtually any reasonable proposal that will stimulate private sector competition and get the government out of the health care business.

MR. JANUS: Our final panelist, Richard Edwards, is a PhD, a graduate of the Harvard Law School. He received his doctorate at Columbia University. He is currently the Frederick R. Kappel Professor of Business-Government Relations at the School of Management at the University of Minnesota. For the last several years, he has been the Chief Government Relations Officer and Senior Vice President of the Metropolitan. He's also served eight years with the Health Insurance Association of America. He's been a teacher, a writer and a public speaker of some note, particularly on the subject that is before us. That subject is the balance of state and federal regulation and what the effects might be if we went to all state or all federal regulation.

MR. RICHARD EDWARDS: My assignment is to offer a perspective on two issues: The probable future balance between state and federal regulation of insurance, and the implications of an all-federal or all-state system of insurance regulation.

The second issue lends itself to summary disposition. I cannot envisage a combination of circumstances that would lead the Congress to make a full preemption of insurance regulatory powers and leave the states totally out of the picture. That simply is not politically feasible.

Conversely, I also cannot imagine a situation in which the Congress would surrender all of its insurance regulatory powers to the states and leave the national government without authority over such a major sector of the economy. That is also beyond political feasibility, partly because of the scope and

nature of current federal regulation of insurance and partly because of the social sensitivity of insurance.

Thus, it is my opinion that the critical question for your consideration is the probable future balance between federal and state regulation. Rarely does a major change in public policy, or a major reallocation of regulatory authority within our federal system, occur without being in direct response to some significant change in the capacity of the regulated industry to meet public needs, or at least in the public's perception of that capacity. Thus, our real inquiry should be: Are there any current social or economic trends or developments which are of sufficient significance to cause the Congress to reassess the existing distribution of insurance regulatory power between the national government and the states?

I suggest that there are at least five such trends or developments.

The first, and clearly the most important trend or development, is the liability insurance crisis. I recognize that this panel is addressing life and health insurance rather than liability insurance. But I suggest that since the same system of state regulation addresses all forms of insurance, congressional correction of what it perceives to be the inadequacies of liability insurance may well be accompanied by modification of life and health insurance regulation.

The various sectors of the insurance industry are too interdependent, from a congressional perspective, to permit their separate jurisdictional treatment. I cannot envisage a regulatory structure in which Congress would allow the states to retain regulation of life and health insurance while placing liability insurance regulation under a federal agency. Therefore, I hope that the life and health insurance industry is cooperating with the liability insurance industry to meet the threat.

The liability insurance crisis is characterized in the June 1986 issue of *Dun's Business Review* as having "reached a fever pitch" and as having become "one of the nation's hardest political issues." Businessmen polled by the U.S. Chamber of Commerce ranked product liability as second only to the deficit as

the highest priority issue for the federal government -- far, far ahead of tax reform. See John M. Barry, "Congress Tackles Liability Insurance," *Dun's Business Month* (June, 1986), p. 60.

The central issue of the liability insurance crisis is the availability of such coverage at rates which the insureds can afford. The crisis appears to impact virtually every phase of the American society and economy. For example, the January 21, 1986, issue of the *Wall Street Journal* contained the results of a survey conducted by that distinguished paper. The major conclusion of the survey was that "the soaring cost and worsening shortage of liability insurance was taking their toll on businesses, professionals and local governments across the country. The crisis is forcing companies to raise prices or accept smaller profits, change their operations and eliminate products and services."

The *Wall Street Journal* survey also produced such findings as the following:

a. Many major industries like the drug, chemical, railroad, utility, hazardous-waste-disposal, banking, thrift, auto, electronics, steel, oil, retailing, and entertainment industries are setting up mutual insurance companies. Some of these industries are collaborating together in one company.

b. High malpractice premiums for architects, engineers and accountants, not to mention physicians, are causing major problems for professionals.

c. Because of high premiums local governments are cutting back on liability insurance. Some have had to cut services or not offer new ones.

d. Fields such as chemicals, financial institutions, health care municipalities, oil, pharmaceuticals, service industries, transportation, professional malpractice, and earthquake coverages have all been heavily affected by the high cost of liability insurance.

e. Many major companies have lost their outside directors because they can't obtain Directors and Officers liability coverage.

With such broad impact upon our social and economic structure, it is not surprising that Congress has the issue under consideration. The February 24, 1986, issue of the *New York Times* reported that because of the high cost of liability insurance, Congress has been pressured to regulate the insurance industry, which the industry strongly opposes. In hearings held in Washington in February 1986, lawmakers recounted the problems their constituencies encountered who were either unable to buy insurance or had to pay huge increases in premiums.

The Senate Commerce Committee is now considering a series of product liability and tort reform bills: one by Chairman Danforth, one by Senator Kasten and one by Senator Slade Gorton. Several other senators have indicated their intention to offer amendments to those bills.

The major points addressed by those bills and by the proposed amendments to them include:

a. Joint and several liability: Under current law, a defendant with even a one percent interest in a lawsuit can be held liable for 100% of the damages;

b. The so-called "State of the Art defense," which would provide that a defendant would not be liable for developments not foreseen at the time a product was developed;

c. A cap on punitive damages equal to twice the compensatory damages;

d. A requirement that the plaintiff pay the defendant's legal fees in the case of frivolous litigation; and

e. A provision that the defendant would not be liable for punitive damages if he or she complied with all applicable government standards.

Senator Rockefeller of West Virginia plans to offer an amendment which could strip the insurance industry of its McCarran-Ferguson protection, and Senator Simon of Illinois has already introduced bills which would:

a. Remove the antitrust immunity afforded insurers under the McCarran Act as it applies to property/casualty companies; and

b. Require such companies to divulge loss information by class of liability, to disclose the percentage of policies cancelled, to provide a list of classes of business in which premiums or coverage were increased or decreased, and to report investment income.

All this should be viewed in the light of two related and very significant facts, both of which antedate the liability insurance crisis:

a. The Reagan administration favors repeal of the McCarran Act antitrust exemption, and

b. For the past 18 months, the Chairman of the House Judiciary Committee, Peter Rodino of New Jersey, has been holding hearings in an effort to gather support for his position that the McCarran Act antitrust exemption should be repealed.

Would Congress repeal the antitrust exemption of the McCarran Act and at the same time reaffirm its preference for state regulation of the business of insurance? We are not likely to know this year, but preparation for all possible alternatives should be under way. It is therefore apparent that the product liability crisis has already restored the McCarran Act to active congressional reconsideration.

The second of the five trends or developments threatening state regulation is the reduction in the number of Americans covered by private sector health insurance. The June 3, 1986, issue of the *Wall Street Journal* reported that the number of Americans without health insurance increased from 28.6 million in 1980 to 35.1 million in 1984. That represents an increase in the under 65 uninsured population of 14.6% in 1980 to 17.1% in 1984.

The problem is exacerbated by the fact that "half of the uninsureds are working. Many small companies and self-employed individuals have found it too difficult to pay rising medical-insurance premiums. . . . In all, one in every

five children in the U.S. isn't covered by health insurance." (Jennifer Bingham Hull, "Growing Number in U.S. Lack Health Insurance as Companies, Public Agencies Seek to Cut Costs," *Wall Street Journal*, June 3, 1986.)

The third trend or development which threatens state regulation is the integration of financial services. You are all familiar with the origins and nature of that development. A few major companies have actively proposed optional federal charters for those insurers who wish to diversify into a broad range of financial services. But today I want to invite your attention to a regulatory feature which has not received a degree of attention commensurate with its importance.

I refer to the fact that the committee structure of most state legislatures, as well as the cabinet structure of most state governors, reflects the assumption that at least the insurance, banking and securities activities of our economy will be conducted by separate companies. Thus, in each house of the legislature there are typically separate committees for insurance, banking and securities. Similarly, in the cabinet of most governors, there are separate commissioners, directors or superintendents for insurance, banking and securities.

If the public actually prefers the integration of those three financial services, perhaps with others -- a point on which the jury is still out -- then two critical regulatory questions will confront most of the states:

a. Who will coordinate the formulation of regulatory policy for integrated financial institutions among the three committees of each house of the legislature? and

b. Who will coordinate the implementation of the regulatory policy for such institutions among the three officers of the governor's cabinet?

The danger, of course, is that proponents of increased regulation from Washington will leverage such facts into a contention that major changes in the delivery of financial services have made state regulation of financial institutions obsolete.

The fourth trend or development which threatens state regulation of insurance is the internationalization of the economy. The availability and cost of all forms of insurance are major factors in virtually all commercial transactions, and there is much evidence that an increasing share of such transactions takes place across national boundaries.

One of the problems of managing international business is that commercial law has lagged behind the evolving world of economy. For example, there is no international counterpart to the uniform commercial code, and no statutory base shared by all parties to the transaction, as is the case with the contract between or among parties domiciled in different states of the union.

A similar observation may be made with respect to insurance across national boundaries. Although the insurance codes of the fifty states differ in many respects, there is a substantial vein of agreement upon key concepts to guide the parties to an interstate insurance transaction. But there is no such vein of agreement to guide the parties to an insurance transaction across national boundaries. Furthermore, by hypothesis such transactions often have the potential for impacting foreign affairs, a domain within the exclusive control of the national government.

The fifth trend or development which may be a threat to the continuance of state regulation springs from the various proposals to reform the federal antitrust laws. By an accident of history, the McCarran-Ferguson Act is a part of such laws. There is a growing recognition that antitrust policies formulated in 1890, when the Sherman Act was enacted, and in 1914, when the Clayton and the Federal Trade Commission statutes were enacted, need modification to bring them into harmony with the realities of worldwide competition with foreign companies which are under no or lesser antitrust restraints in their respective countries.

Thus there is a possibility that major revision in the antitrust laws might include congressional reconsideration of the McCarran Act.

Although these five trends or developments collectively pose a threat to the preservation of state regulation of insurance, I believe the insurance industry

has both the will and the resources to prevent any substantial enlargement of federal regulatory authority over the business of insurance. To achieve that goal, however, three industry responses will be needed. Inaction or business as usual will not be enough.

1. There must be a concerted effort by the industry to assist in the correction of the root causes of the liability insurance crisis. The principal cause, in my judgment, is the failure of the courts and the legislatures to control runaway juries, punitive damage awards and abuse of class action litigation.

   The Institute for Civil Justice, part of the Rand Corporation, has for several years been providing leadership in this regard. Many of your companies already support the Institute's research and educational efforts. They create a public awareness that the nation is not well-served by jury efforts to punish corporations with punitive damage awards which have no rational relationship to the amount of legitimate compensatory damages. The Institute for Civil Justice deserves additional support, but it cannot do it alone.

2. By the use of industry pools for the uninsured, or other devices that you actuaries can design, a way must be found to halt the annual reduction in the number of Americans not covered by private sector health insurance. This is an area where the cooperation of the Society of Actuaries and the Health Insurance Association of America would be a natural. Both organizations have extensive experience and techniques available, as well as their technical and political feasibility. It is also an area where the cooperation of the state legislatures and the state insurance commissioners will be essential.

3. The insurance industry has long been the target of sporadic but intense criticism by publicity-seeking self-appointed consumer defenders -- in both the public and private sectors -- who choose to make their living by hurling charges at one of the most socially legitimate institutions in America, the life and health insurance industry.

> Clearly, an answer to that disagreeable phenomenon is for the industry to respond fully and promptly to each such charge using data in your collective possession to demonstrate the truth and refute the credibility of your critics. It is even more important that your industry keep reminding the American people of the enormous economic and social benefits which the institution of insurance provides for our nation.

By way of summary and conclusion, I do believe that there is a series of forces which collectively constitute a threat to the continuance of state regulation of insurance, but I also believe that the insurance industry has both the will and the resources to repel each of those threats. Finally, I think there is virtually zero probability of the present system of dual state and federal regulation of the insurance industry being terminated either by a total preemption of the field by the national government or by a total surrender of the field to the states by the Congress.

MR. JANUS: Do you believe that the tax laws being proposed will create a significant shift from savings to spending or from capital development to spending? What effect do you think that might have on the future of interest rates and inflation, say, four or five years from now?

MR. SCHNEIDER: Much is being done in Washington right now to try to forecast the effects of the tax bill on the economy. I personally am somewhat amazed that Congress can be considering such sweeping tax reform proposals without giving much more consideration to the potential economic impact of various proposals. I think that much lip-service is being given to the effects of cutting individual tax rates and the long-term growth benefits of that for the country. It is hard to deny that the idea underlying cuts in tax rates has some appeal to it -- making people more productive and more willing to work harder to earn extra money so that they can retain more of their marginal dollar.

There are some provisions in the law itself that could significantly affect the long-term growth prospects of the country. An example is the disallowance of deductions for consumer interest. The old saying is, As General Motors goes, so goes the country. I think this still has considerable truth to it. How

will the disallowance of deductions for consumer interest affect sales of automobiles in this country? Will it lead to more rentals of automobiles by individuals?

Some of these questions are very complex economic issues, and I think that Congress at this point is caught up in the tax reform mode and should be giving some further consideration to some of the economic impacts of the various proposals. Some of the retirement plan proposals seem to discourage long-term savings. I don't think that's the hoped-for result for the overall tax bill.

MR. JANUS: I get very concerned when I see the IRAs going out the window, even though we wind up with the same income. The incentive to save money disappears, because you don't have to save it to get the tax deduction. When capital gains are not given any preference and the investment tax credit goes, I get very concerned. We may be developing a two year boom period with this tax reform act and then find ourselves in a very highly inflationary situation with a lack of capital and very rapidly rising interest rates. I see this in the short term as being very helpful to the economy, but in the long term being very harmful.

Many of these tax incentives that have been taken out of the program, such as investment tax credits, had purposes at one point in time. Presumably those purposes will develop a priority again. Which ones do you think might come back into the tax act over the next few years as preference items?

MR. SCHNEIDER: I think your point on the investment credit is a very good one. The investment credit over the past 25 years has been instituted and repealed three separate times. That is a very likely candidate, in my view, for potential reinstatement if the effects of the repeal are to significantly reduce the investment by corporations and capital.

I think some of the other purposes of tax shelters that were thought beneficial when those tax shelter provisions were enacted, especially real estate, may come back in. I think it's widely predicted that, for example, residential rental rates are going to have to rise significantly because of the disallowance of real estate tax shelter benefits. I don't think that Congress would

resort to the type of depreciation benefits that are allowed for real estate under current law. But, I think we may see a reinstatement to some extent of benefits flowing through to individual investors for passive real estate losses.

It is possible that some of the retirement plan provisions might be affected further. Congress is continually tinkering with the limitations for contributions under defined benefit and defined contribution plans. It is tightening the discrimination rules with respect to those plans. A result of this bill and prior law is that many companies, especially the small employers, may decide that qualified retirements are more trouble than they're worth. We might wind up with fewer people being covered by qualified retirement plans than under current law. That is an area that we may see further adjustments to a couple of years down the road.

MR. JANUS: Mr. Prussin, the ratcheting down on the various federal programs might well be in process. Do you believe that the federal or state governments perceive health primarily as a public utility, and therefore believe that profits should be closely regulated?

MR. PRUSSIN: I view this from two perspectives. On the one hand, there is still a very strong feeling widely held that the provision of health care should be non-corporate and non-profit. Of course the individuals providing health care, specifically physicians, tend to have substantial incomes and live very well, so it is in fact not non-profit. But there still is a feeling that this is something in our society that we don't want to have controlled by corporations whose motive is to make a profit, as opposed to corporations that are non-profit and are there to serve the public interest. This view is changing quite rapidly with the entry of some of the large corporations into the broader spectrum of delivery, such as Hospital Corporation of America and Humana.

On the other hand, you have the organizations that are not involved in the direct delivery of health care, specifically the insurance companies. As you know, the states, in approving rates, have always been quite concerned about payout ratios, levels of profit and administrative costs. I think that will

continue. It is viewed from the very different perspective of the actual hands-on involvement in the delivery of care. As insurers become more involved in managed delivery systems, which I think is going to be very substantial in the very near future, you will find that there is a different view towards profit. It's not only a view of limiting profits, but it is questioning whether profit making is appropriate in health care.

MR. JANUS: As I was listening to the discussion about regulations for the health care industry and Medicare demonstration projects and other federal encroachments into the health insurance industry, I saw a dichotomy between what is currently called insurance and what exists for certain Health Maintenance Organizations (HMOs) or Competitive Medical Plans (CMPs). What do you see as the role of the states in melding the insurance concepts with these health care delivery systems?

MR. PRUSSIN: The states at the current time tend to view regulation of insurance as something that is somewhat separate and apart from the regulation of managed delivery systems. Particularly under Medicare, they tend to leave the regulation to the federal government through its Medicare contracting mechanism. But the states even view commercial members in managed delivery systems as very different from insurance and tend to specifically exempt them from insurance regulations. Of course that creates some competitive problems for insurers who have certain mandated benefits that are not applicable to HMOs and other mandated organizations.

I think, though, as the insurers become more and more involved with managed delivery systems, the distinction will break down. We will see a movement toward a unified regulation of what is currently insurance in the strict sense and what is currently managed delivery systems. That will probably not result in insurers' being regulated more stringently. Instead, managed delivery systems may be regulated more stringently, particularly with respect to benefits and insolvency arrangements.

MR. JANUS: Do you have a view on the role that states should take, at least with HMOs and perhaps third party administration of group insurance or self-insured plans?

MR. EDWARDS: I agree with the view just expressed. But I recall that in the late 1950s until the middle of the 1960s, there was a storm of criticism against the health insurance industry for maintaining its traditional view that its job is to finance the delivery of health care and not to provide for the delivery of health care. Part of that criticism was based on the argument that as long as the insurers asked virtually no questions about the delivery of health care, that that would be an inflationary escalating force in itself. That was at a time when people were more concerned about inflation than they are now.

There is, however, a problem about the marriage of delivery of health care and insuring the risk. We are talking about two very different intellectual disciplines. There are maybe 200-300 people in the United States who are capable of dealing with both in a competent matter. Out of a population of 230 million or more, that's not a very high percentage. Managing the integration of the insurance function with the delivery of the health care function involves two very separate kinds of things, even though strongly related. I think you have a problem. We are watching that go on all through our society now, where corporations are in a wild acquisition mode. All of a sudden they have acquired something that looked like a cash cow if they ever saw one. But managing it turns out to require different kinds of people than they had, different talents, and different backgrounds. All of a sudden there is a divestiture of what they had acquired.

It ought to come out so that a maximum number of people would be given good, high level health care with a minimum impact on the taxpayer, yet providing necessarily a high standard of compensation for the providers. They have earned it, and they deserve it.