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STATEMENT

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BEFORE THE

GOVERNOR'S ADVISORY COMMISSION

ON

LIABILITY INSURANCE

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I am pleased to present our views on taxation of the insurance industry. We have had an active interest in this area for the past 6 years. In 1981 we submitted a report to the Congress on taxation of life insurance companies. Earlier in 1985 we issued a report on taxation of the property/casualty insurance industry.

We believe that the Congress should reexamine several aspects of the tax code dealing with property/casualty insurance companies. These aspects include the deduction for loss reserves, the deduction for acquisition expenses, and the protection against loss account. Before explaining why we believe certain parts of the tax code should be reexamined, I would like to provide some background information on property and casualty insurance company pricing strategies, a financial overview of the industry, and the impact on the industry of certain current tax provisions. I would also like to comment briefly on the consolidation of property/casualty companies with parent companies that are not in the insurance business.

PROPERTY/CASUALTY COMPANY PRICING STRATEGIES

A property/casualty company derives its income from underwriting gains (the excess of premiums over claims and expenses) and investment gains. Because of investment gains, a property/casualty company can still have net income even though its

premiums alone are not large enough to cover claims and expenses. Thus, even though a company has a ratio of claims and expenses to premiums in excess of 100 percent, which normally would indicate the company had suffered an operating loss, it may well have a positive net income.

The ability to offset underwriting and investment income can play an important role in a company's pricing strategy--that is, the amount of premiums it charges for the insurance that it offers. For a number of years, many companies have been willing to charge lower premiums to compete for certain insurance lines, even though they will have ratios of claims and expenses to premiums in excess of 100 percent. (For example, in some major lines of business, such as medical malpractice and other liability, these ratios have been more than 160 percent.) The companies expect to make up the premium shortfall through investment income. Through the incremental volume of premiums resulting from this pricing approach, companies are able to generate a larger amount of net cash flow which they can then invest to earn additional investment income. For instance, in 1983 when the industry had a combined ratio of claims and expenses to premiums of about 112 percent, which produced an underwriting loss of about $11 billion dollars, it still had a net gain of about $9 billion and generated a total of about $12.1 billion in net cash flow, as reported by Best's Management Reports.

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

FINANCIAL OVERVIEW OF THE PROPERTY/CASUALTY INDUSTRY

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

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

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

Table 1

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

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

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

Table 2

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

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

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

While firm figures for 1985 are not yet available we do have estimates. For a number of reasons, including the pricing strategies referred to earlier, the underwriting losses in 1984 and 1985 reached record highs. However, as shown in table 3 below, the investment gains have also been increasing with the result that the 10 year figures for 1976 through 1985 (based on estimated 1985 data) still tell the same story of high gains with overall negative taxes.

Table 3

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

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

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

IMPACT OF CURRENT TAX PROVISIONS

Our analysis of the foregoing financial data gives insight into how current tax policy affects the property/casualty insurance industry. As a result of certain tax advantages, many

property/casualty companies have not paid federal income taxes for a number of years and, in fact, have qualified for refunds or the ability to carry back or carry forward losses for tax purposes. We found from a study of the top 29 groups of property/casualty companies representing more than 60 percent of the industry's premiums, that as of December 31, 1984 these groups had carryforwards of almost $6 billion. This figure should be kept in mind in estimating the expected future revenue that will actually be realized from the industry under any new tax proposal.

In addition to the tax deferrals resulting from the treatment of loss reserves, the treatment of acquisition expenses, and the protection against loss account, property/casualty companies can also use tax provisions available to other taxpayers. These tax provisions include excluding interest income from tax-exempt securities and deducting 85 percent of the dividends received from domestic corporations. Between 1975 and 1982, about 40 percent of the gross investment income of all property/ casualty companies was from tax-exempt investments. The dividends received deduction during this period represented about 20 percent of the gross investment income of the companies.

While we presented and discussed these facts in our report, we did not recommend any changes in the application of the exclusion of tax-exempt interest or the dividend received deduction to property/casualty companies. We limited our study to those provisions of the tax code which applied only to property/casualty companies.

CONSOLIDATION WITH NON-INSURANCE PARENTS FOR TAX PURPOSES

Special provisions of the Internal Revenue Code enable property/casualty companies to report losses for tax purposes even when they are operating profitably. These provisions make them attractive subsidiaries to companies seeking to reduce their tax liability. For example, property/casualty companies are required to calculate loss reserve deductions under state regulated accounting rules, which reduce a company's taxable income. Furthermore, under these same state regulated accounting rules, companies may deduct expenses associated with the sale and renewal of insurance policies, even though they are not required to recognize related premium income until is earned. This also reduces taxable income.

If a property/casualty company were independent it might not be able to use these losses immediately for tax purposes. However, if the property/casualty company is owned by a non-insurance parent company all of the losses may be used to offset taxable income of the parent company. If the property/casualty company is owned by a life insurance company the losses that may be used by the parent are limited to the lesser of 35 percent of the subsidiary's losses or 35 percent of the parent's taxable income.

In addition, the basic liquidity and constant cash flow of a property/casualty company assures that funds will be available to a parent corporation for various investments, such as investment in tax-exempt securities. Even in the year of record underwriting losses in 1984, the p/c industry had a net cash flow of $11.8 billion.

Table 4 shows the 20 largest groups of property/casualty companies broken out by those with a non-insurance parent company and those that stand alone or have life insurance affiliates.

Table 4
Twenty Largest P/C Groups - 1984
(in millions of dollars)

	Number	Percentage of industry premiums	Federal income tax
With non-insurance parent	6	15%	($726.5)
Others	14	38	(536.6)
Total	20	53%	($1,263.1)

Table 4 shows that, of the 20 largest property/casualty groups, the 6 with non-insurance parent companies had large net losses for tax purposes (as shown by negative income taxes). Of the $726 million in negative income taxes generated by the six non-insurance affiliated property/casualty groups, nearly all ($714 million) was used to offset tax liabilities of the parent companies.

It seems clear that property/casualty companies can become important acquisitions for non-insurance corporations. However, the studies we made were inconclusive as to what effect consolidation with non-insurance parent companies had on the property/casualty insurance subsidiary. For example, consolidation with a non-insurance parent did not seem to ensure that the consolidated property/casualty company would grow at a faster rate nor did it seem to have a positive effect on the company's rate of return.

AREAS OF PROPERTY/CASUALTY INSURANCE TAXATION NEEDING CONGRESSIONAL REEXAMINATION

We indicated in our report on the taxation of the property/casualty insurance industry that the Congress should reexamine three areas of the tax code.

These areas are

- --the deduction currently allowed for loss reserves;
- --the practice of currently deducting all of the expenses associated with the sale and renewal of insurance policies; and
- --the protection against loss account, which defers a portion of a mutual company's income to provide a cushion for catastrophic loss.

Our conclusions and recommendations in each of the three areas were as follows:

First, we concluded that the present practice of deducting in the tax year the full (undiscounted) amount of future estimated settlement costs overstates the loss reserve deduction. We suggested that the Congress consider amending the tax code to provide that for tax purposes loss reserves be discounted in calculating the loss reserve deduction. We further stated that the discount rate should be based on a moving average of each company's pre-tax net return on its investment portfolio.

We estimated discounted loss reserve levels at several discount rates for 1980-82 (holding all other factors constant) and the additional tax liability that would have resulted. If a hypothetical discount rate of 7 percent had been used by all

companies in 1982, the deductions taken would have been reduced by about $1.3 billion, and tax liabilities would have been greater by about $613 million.

Second, we concluded that the present treatment of acquisition expenses fails to match expenses and revenues. Currently, the tax code permits all acquisition expenses to be deducted immediately, even though the premiums associated with these expenses are spread over the life of the contract. In this case we suggested that the Congress consider amending the tax code to provide that acquisition costs be allocated over the life of related contracts so that these costs are matched with premium payments generated by the contracts.

If acquisition expenses were allocated when revenue is recognized, then taxable income would increase. We estimated the additional tax liability that would have accrued for the years 1980-82 if this change had been made and everything else had remained the same. Based on these assumptions, the additional tax liabilities would have been approximately $164 million in 1982.

It is important to note that even if both of these changes in the tax code had been effective, the Treasury would have received only a portion of our estimated amounts of additional taxes. Some companies were showing losses for tax purposes and had large outstanding loss carryforwards. Furthermore, companies might shelter more of their investment income and thereby mitigate the tax impact of any increases in income.

This could be done through increasing their holdings of tax-exempt securities or equity securities of domestic corporations.

Third, we concluded that the protection against loss account may not protect mutual companies against catastrophic losses because the money in the account is not earmarked for that purpose. Thus, if a catastrophic loss were to occur, the account does not necessarily ensure the company's ability to satisfy its contract obligations. In this case, we recommended that the Congress consider whether or not this special tax preference for mutual property/casualty insurance companies should be retained in its present form.

CONCLUSION

In conclusion, the financial information we have presented indicates that the property/casualty insurance industry has paid a relatively small share of its net income in federal income taxes in recent years. While we are not in a position to comment on what might be an appropriate federal tax burden for the industry, we do believe that the Congress should consider amending the tax code along the lines suggested in our report. In our view, the changes would result in a better match of the industry's revenues and expenses and represent a more rational approach to its taxation.

This concludes my prepared remarks. I would be glad to answer any questions you may have.