Insurance and Insurance Regulation

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The Social Responsibility of Insurance Regulation

A few miles north of here, on Morningside Heights, people long thought to have the habit of obedience are in revolt against an institution felt to control them but to be beyond their control. It is hardly an isolated incident, and this is a good season for many another institution to measure itself against the present expectations of those it was created to serve.

What goes for other institutions goes for our own, and now is a good time for use to look anew at the responsibility of insurance and, especially, at the social responsibility of government as regulator of insurance.

We can begin by looking first at where we stand.

Much of the literature on government regulation of business comments on the tendency of the regulator gradually to adopt a view of the world similar to the view held by the regulated industry. It is a natural consequence of similar training, similar tasks, similar data and similar techniques. It has nothing to do with whether the regulator is disposed to be friendly to the industry or hostile to it. It certainly does not mean that the industry and the regulator will agree on the answers. It does mean they are likely to agree on the questions.

Regulation of any business can easily become, for both sides, a closed system whose values are established by reference to other parts of the same system.

If the industry can measure its civic performance by how often it secures the approval of government, then its representatives have a clear measure of how well they're doing. If the government regulator can measure his thoroughness or independence or wisdom by how hard a time he gives the industry, or how often he says no, then he too has a clear and comfortable rule to live by.

Such a system can be busy and effective, within its own frame of reference, and can be quite congenial to both industry and government, but it leaves little room for questions to intrude from outside. Having quarantined itself, such a system can stay still while the outside world moves. More and more it can fail through unawareness to do that which the rest of society, having changed in structure and expectations, needs and wants done in the regulated area.

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As scholars of management, you know that this drift toward similar views of the world or toward a closed system is reinforced by a characteristic of institutional behavior that occurs far beyond the field of regulation. It is the tendency of the large organization—especially one with technical competence and a strong professional tradition—to do today what it did yesterday without incident.

We can trace this tendency partly to the quasi-judicial character of some operations, with their emphasis on regular procedure and consistent decision. We can trace it partly in the disposition of technique to elaborate itself, to increase its momentum within the decision-making process, and to foreclose consideration of new objectives that are outside the technical system. Finally, we can trace it pretty deeply into human nature—change is disquieting.

If we acknowledge that regulation can become a closed system, and that any large organization can develop a certain straight-line inertia, then we are in a pretty good position to talk about the social responsibility of government in insurance regulation.

Insurance has too important a public role not to be affected by changes in the surrounding society. The distribution of risk on a fair and stable basis is essential to personal and commercial financing, to an efficient disposition of resources, to the ability to plan ahead and to simple peace of mind. Many of the functions of private insurance in the United States can be, and in other countries are, performed directly or indirectly by government, and the stakes for the industry in staying responsive to changing public demands are obviously high.

Similarly, it is appropriate for government to cast its role in some proportion to the social importance of what is being regulated. Whatever may be the case in other industries, it is fairly clear that, in insurance, government regulation is no longer simply the application of countervailing power against a dominant economic group that might otherwise abuse its own power. Today government has an additional responsibility to encourage and guide and, where it is important and necessary enough, to require the regulated industry to respond to the current needs of society at large. To do this, government has to exercise an informed judgment as to what the evolving public needs are, and should develop its own position early enough and on a sufficient scale. To succeed, the government regulator has consciously to overcome his own natural tendencies to operate a closed system and to keep going in a straight line.

The social responsibility of insurance regulation, then, is to recognize that changes in and out of insurance are constantly altering the social responsibility of insurance regulation; that its goals should change accordingly; that sometimes it falls to government to lead the industry toward change; and that it always falls to

government to make the conscious effort to order its own house by current intelligence and not by habit.

In our own work in the New York Insurance Department, we have been trying to meet this responsibility. Examples of the effort are in our proposals on a pool for fire insurance in central cities, on flexible interest rates on life insurance policy loans and on insurance holding companies and diversification, as well as our participation with others on universal health insurance and the Governor's study of the auto liability system.

But re-examining one's own goals and one's own relevance to a changing external situation is a job that is always difficult and never complete. We must continue to ask where the evolving social responsibility of insurance and of insurance regulation is likely to lead. Are the conventional goals still the only ones by which history will judge us?

Consider, for example, the deep and durable belief that the purpose of regulation is to protect the policyholder. Not surprisingly, this maxim places the regulator in exactly the same world as the industry; his constituents, as it were, are those people already in a contractual relationship with insurers.

But is the maxim a reliable guide to our evolving social responsibility?

Recent government action to make property insurance more readily available in the central city would suggest that we are also trying to help some people who are not policyholders—whose problem, indeed, is that they cannot become policyholders. The movement toward universal health insurance suggest that government will act out of a sense of duty to people who neither are policyholders nor want to be policyholders.

Freedom of contract and freedom of underwriting are obviously being subordinated to other goals. It is not the first time; analogies already exist in automobile insurance. But these steps are being taken, more and more, by government as regulator—thereby improving the technical product, increasing the participation of private industry and giving the regulatory agency new vigor. The facts of this new social responsibility of insurance regulation are becoming clear. The slogan will catch up later.

A second place to look for possibly changing goals is in rate regulation of property and liability insurance. It is now twenty years since the prevailing rate regulatory laws were enacted, and it is common knowledge that they were enacted for a large number of reasons, some of which do not persist today. The law sets forth standards for rate review, but these should not be taken as fully expressing the philosophy or reason underlying the law.

What, indeed, is the objective of a modern rating law? Is it to keep rates down, or to keep rates up to preserve the institutional structure of the industry, or to promote uniformity of rate or predictability of rate? Is it to help the consumer evaluate the price and quality of the insurance product he is buying? Is it to encourage competition, and does competition mean the same thing to all of us? Is it to attract capital to the insurance operation, or to maintain continuous markets, or to make up for the lack of antitrust standards, or to balance the traditional freedom of underwriting, or to smuggle taxes and subsidies?

Several of these, and others, are legitimate objectives. Each kind of rating law, and each way of administering it, will give a different set of objectives precedence over the others, and it is our responsibility to keep our priorities abreast of changes in the regulated industry and in the expectations of the public.

A third example of the value of re-examining our thinking about what we do is in regulation for solvency. Sometimes we have indulged ourselves in the view that solvency—that is, the absence of failures of insurance companies—was entirely dependent on the quality of regulation.

Vigilant regulation, some thought, could entirely prevent insolvencies. Certainly it helps, and, when reinforced by high standards for entry to the business, regulated rates, conservative underwriting and a rising stock market, it can achieve a very high percentage of success, as, indeed, it has done and should continue to do in New York. But we should not delude ourselves with the notion that insolvencies can't happen here. They can happen here, and in the last two months we have put one company into rehabilitation on that ground and are moving to rehabilitate another.

The point is that no one in any jurisdiction has ever figured out a foolproof way to prevent men from making mistakes, losing money or having bad luck.

All we can do, realistically, is require adequate capitalization, guard against management activities that threaten the financial condition of the company, and detect deterioration quickly and help in its repair. That is a lot, and new techniques for handling data will enable us to do better than ever. But it is our responsibility to accept fully the fact that all these steps will sometimes not be enough. Any balanced system of regulation has to provide, in ways consonant with the changing expectations of society, for distress situations, where the stranded policyholder needs government strongly on his side.

These are just three of many areas where the evolution of thinking in and outside the field of insurance impresses on us the social responsibility to be sure that what we are doing is a relevant and desirable contribution to the well-being of society as a whole. The abiding question is whether we are doing what is important

now, and not distracting ourselves with what is not important any longer. The main social responsibility of insurance regulation may be the willingness to keep asking that question, and to act on the answers.

Purpose and Technique in Insurance Rating

Not too long ago, property and liability insurance rating was the domain of private government. The system had its comforts, but as its methods grew in refinement and momentum, the legal and economic mores of the community at large moved further and further away from those of the insurance pricing system. Naturally, the stresses on the system built up and up, and finally it broke.

A legal revolution came first, followed shortly by a revolution in the insurance economy. The legal revolution shifted much of the decision-making power away from the private government and gave it to the public government. The economic or marketing revolution made what had been the private government much less like a government, even within its surviving jurisdiction.

Then the public rate regulators became more aware of the difference between their priorities and those of the rate makers in industry. The guiding principles were agreed upon—that rates not be excessive, inadequate, unfairly discriminatory or otherwise unreasonable—but in fact these principles were so abstract as to be useful mainly in helping one justify a decision reached either intuitively or on other, more precise grounds. So there developed a kind of adversary system, with an implicit burden of proof on whoever advocated change, whether for a rate increase or a rate deviation.

This adversary system is the special province of actuaries and other competent professionals. The system, perhaps not unlike its predecessor, has been apparently stabilized by the complexity and steady refinement of its techniques.

Not surprisingly, the process of implementing our rating rules has shown more intellectual and operating vitality than have the rules themselves. People think more systematically about technique than about principle, and evolutions in technique can be more smoothly fed into the decision-making machinery, where they achieve legitimacy, than can comparable evolutions in underlying precept.

In the short run, this is certainly innocent and probably desirable, but in the long run it can drain the vitality from the institution in which it occurs. Where dynamic and articulated techniques implement vague and static principles, technique soon comes to control principle—or, rather, to foreclose consideration of new information and new objectives that are outside the technical system.

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Already our refinement in rate regulatory technique has run far ahead of our thinking about the purposes of the whole exercise. It has run ahead of our understanding of whether the rules and procedures, which we apply with such refinement, are consonant with changed conditions—whether the established rules are directing our effort and attention toward what is important now and relevant now and responsive to the present needs of the public.

This is the stuff revolutions are made of. When circumstances change and the guiding precepts do not—while the methods become more and more thorough—the whole system comes under stress, and unattractive symptoms are apt to break out. Those involved, and observers as well, will be tempted to throw out the whole set of underlying rules and procedures, or to give custody of them to someone new.

In general, the process goes something like this. Rules are set down which apprehend reality in a way thought desirable by the public. Over the years, diligent implementation builds upon those rules an outer shell of precedent and detail. The system grows, and grows more elaborate, and becomes a closed system, with each new layer derived from other parts of the same system. Soon the rules at the core are obscured; only the shell is in contact with reality. Then circumstances change, or public expectations change. But the system cannot respond—indeed, the danger signals from outside may not for a long time penetrate to where the rules are. At some point the frustrated public, which may have begun by seeking only evolutionary improvement, throws out the whole system.

If a system, either of rules or of organization, has to go, perhaps this is the best way to go—involving the most honor and the briefest pain. But it is tragic to die of a surfeit of virtue, and worth avoiding. How, then, can we respond to the present demands upon our rating system?

There are any number of possible responses, but two are especially promising.

The first useful response would be to identify the proper, evolving goals of government in the rating field. It is now twenty years since the prevailing rate regulatory laws were enacted. They were enacted for a large number of reasons, some of which were better than others and some of which do not persist today. Much has changed in and out of the insurance economy in the intervening years, and we can properly ask what society today should expect of insurance rate regulation and whether our law and techniques meet that expectation.

The second good response, and one we can pursue right now at a less abstract level, is to keep our rating principles as vigorous as our techniques and to be alert lest changes in the insurance business or in the economy leave our rating principles behind. One specific possibility now under consideration by the New York

Insurance Department is the application of trend or projection factors to the various elements of the property insurance premium. An obvious example of such a trend is the effect of inflation on loss costs, a factor which New York never has recognized in property-liability rating. When our present rating law was written, inflation was not much of a factor, and it was certainly not a credible trend. But much has happened in the economy, and in our understanding of it, since then. In may lines, loss payments go for goods and services whose dollar cost has been rising, and what portion of the loss goes to pay for what good or service is known with some precision, as is the past rate of inflation of the cost of that good or service.

Rating is supposed to be a matter of prediction, not recoupment, and our rating law requires that we consider prospective as well as past experience. But the word "prospective" in the law does not suffice to establish an operating rule, and, without a conscious effort to explore trend factors as a question of principle, the matter would be foreclosed simply by the natural tendency of technique to control principle. Year after year, the advocates would face each other, and almost every time the winner would be the defender of the status quo, not necessarily because he was afraid of change, but because he would honestly conclude that the other fellow had not proved his technical case, that the support for the trend was not as real as the past experience data supporting the other aspects of the rate filing.

Yet at some point, it becomes fair to ask whether the remaining uncertainties in the exact degree of future inflation still justify our acting as though there were no inflation at all. At some point, the reaffirmation of a decision that was correct when first made becomes no longer correct. The reality will have slipped away.

If our system is to remain strong and relevant, principle must lead technique, and the key is not so much deciding questions of principle as identifying them. Only in that way can we be sure that our technical machinery yields answers to relevant questions and yields results that help insurance and insurance regulation meet the current needs of society.

A small shift in reality can make an elaborate system look quaint, with all its brilliant technique becoming, to the eye of history, an exquisite irrelevance.

One of the main public responsibilities of a regulatory agency is to recognize that changes both inside and outside the regulated field will alter its public responsibilities. One of the most difficult parts of our job is constantly to re-examine our own priorities and to look for ways in which a changing external situation may call for changes in what we do. If we fail, it will be no excuse that we were held prisoner by our own competence.

Ritual and Reality in Insurance Regulation

In recent months, we have seen one after another of our great institutions—public and private, national and local—come under siege, and the siege was usually laid down by people the institution was created to serve—its students, its citizens or its customers.

These events do not mean that our institutions have suddenly gone bad, but only that different things are now expected of them and that, when rigorously measured against new expectations, the institutions are found wanting. The events dramatize how difficult it is for an institution, especially a large and complex one, to adapt to the changing expectations of its constituents.

If institutions generally are not good at adapting to changes in their environment, government regulatory institutions may have special difficulty and be in special danger, for the regulatory process may bring out those traits that are most resistant to change.

In most regulation the public is only fitfully interested, and the regulator is insulated from public scrutiny by the complexity and obscurity of the regulatory process, just as the industry is insulated by the mere existence of the regulator.

Left alone with each other, the regulator and his industry unconsciously find a mutual interest in ritualizing their relationship.

The regulator must emphasize law and regularity, against the day he is challenged in court or denounced in public. He thus must look to form and detail, and may look away from the operating realities of the industry and from the expectations of the public. The industry relies on the rituals of regulation to make government behavior predictable and to keep the regulator occupied in areas where interference can be tolerated.

Inevitably, both regulator and regulated come to measure their effectiveness by their impact on each other, and come to live, often quite comfortably, within a closed system.

To what areas do the rituals of regulation tend to confine the attention of government? Often to matters internal to the market, attenuating competition, preserving the institutional structure of the industry, and balancing competitive

advantage among entities of different form, sponsorship or regional allegiance. As a result, too much regulatory energy is diverted into policing the status quo in the regulated industry and into refereeing contests within it.

Those tendencies—to quarantine itself, to exalt ritual and detail, and to become distracted with internal problems of the industry—are, on the record, discernible in regulation of many kinds. It does not seem to matter what is being regulated or by whom or, in a narrow sense, how well. For the competent regulator the snare is not error; it is irrelevance.

If we confine our minds to the rituals of regulation, we will resist change. But we will not prevent it. All we will achieve is to make certain that when change comes—and eventually change always comes—it will be dictated by the rebuffed and the frustrated, and not by us who would honor our institution, share its assumptions and value its continuity.

For any institution, the alternative to intelligent change is not permanence; it is extinction. For an industry regulated in the public interest, the alternative to regulation is not freedom; it is replacement.

To recognize the need for change, and to welcome it, is a sign of strength, not weakness. An institution that can justify evolution only by invoking the spectre of imminent disaster is likely to be an institution incapable of renewing itself from within. Better that we plan our changes calmly and without waiting for crises. In that spirit, I will propose today some changes for my own institution. I like to think they indicate that the New York Insurance Department—whose professional staff is the equal in competence, honor and dedication of any other body of civil servants anywhere—is capable of adapting and renewing even its most basic functions.

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Obviously, we are not concerned with change for its own sake, but only with change for the sake of helping the institution of insurance regulation do its job better. A good starting point is to identify the job, the purpose of our enterprise. Only if we have a clear idea of our overall mission can we have a standard for testing the usefulness of our specific activities.

Should we not try to express simply what we are about? Is it beneath our dignity to compress and weed out the complexities, so that we tell people what is worth their attention?

What, in simple words, is the public purpose of insurance regulation? What is government trying to accomplish that justifies all this activity?

A good, simple answer is that government is trying to help people get the most insurance for their money. This simple formulation does not tell all, but it contains some reminders of the purpose of regulation and some standards for determining whether our priorities are right—whether we are doing the things, and only the things, that further our public purpose.

Helping people get the most insurance for their money begins with helping people. We are reminded that regulation, as a government activity, should serve people. Putting it that way makes it sound obvious, but we have been discussing tendencies in the regulatory relationship that insulate the regulator from outside ideas and that tend to preoccupy him with ritual and with the internal problems of the industry—all of which can lead the regulator to forget whom he was put in office to serve.

The public-spirited regulator needs continuous infusions of the public spirit. If he recognized the danger that regulation will become a closed system, he must seek out ways to keep it open. In New York, we have been trying to go out to meet with the insurance-buying public and especially to seek out those people who are most disaffected with the institutions of insurance and insurance regulation. This is not easy, and certainly it is not always pleasant. But tranquility is not the ultimate value in the public service, and it is part of the work of the regulator to welcome, on a continuous and constructive basis, the fresh thinking of those whose only connection with insurance is being the people insurance is supposed to serve.

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The phrase "helping people get the most insurance for their money" contains a number of other ideas, and I would like to take them up one at a time, and suggest ways of furthering each of these aspects of our public purpose in the regulation of property and liability insurance.

First, helping people get the most insurance for their money concerns, among other things, a person's ability to get insurance.

The availability of insurance has great economic and social value. The accepted loss ratios in much of property and liability insurance indicate that people so value the ability to transfer certain risks of living that they will contribute a third to a half of their premium dollar to the operating expenses of the risk distribution system. It is no wonder that a public which is willing to pay that much to spread certain risks will react forcefully against what it regards as an unacceptable curtailment of its ability to spread those risks.

Generally, government can be expected to act to strengthen or replace the private insurance mechanism when the shortage of insurance is serious enough and the social cost of not acting—that is, of leaving the individual to take his chances

alone—is too high. When government decides it must act—as it has done in auto assigned risk plans, fire insurance pools, catastrophe reinsurance, Medicare, workmen's compensation funds and bans on racial discrimination in underwriting—it can anticipate strong support from the public, for the public encourages government to look beyond insurance as a private contract to insurance as a public function.

Residual markets change, and the work of the industry and government in strengthening those that are socially intolerable is a work that is never finished. It is in the interest of the industry, just as it is the duty of government, to identify and act on those problems early and forthrightly enough that they can be solved with the minimum of suffering and ill will and with the minimum disruption of the private insurance mechanism.

We have such a situation today in auto liability insurance. Auto liability underwriting leaves as residual risks many people who, on their individual merits, may present no special hazard and who—because they are young or old or poor—may be least able to sustain a liability in excess of their insurance protection.

We already have a mechanism for strengthening the market, but it is out of date. The New York Automobile Assigned Risk Plan provides only the limits required by our compulsory insurance law. While it is logical that the Assigned Risk Plan can supply no less, there is no reason why it cannot supply more. In New York today, 10/20/5 protection is so inadequate as to be foolhardy for the driver and cruel to the victim. We simply need to keep our institution up to date. We can do so by increasing the amounts of liability insurance available through the Assigned Risk Plan, and providing auto physical damage insurance through the Plan, at a rate based on experience in the Plan.

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Helping people get the most insurance for their money contains a second idea—that of getting the most insurance, or of making sure that the insurance product is of high quality and reliability.

Experience in many fields has shown, not surprisingly, that where a promise of future performance is sold for present dollars, the buyer is at the seller's mercy. Where, as in insurance, the promise is complex and the seller is more powerful than the buyer, the disparity between the two parties' abilities to look out for themselves is marked.

So for a long time government has stood with the buyer in helping assure the quality of the product. Examples are in the regulation of policy provisions, to see that they are clear and fair; in regulation for solvency or its equivalent, to see that the promise can be performed when it comes due; in regulation of the relationship

between insurer and policyholder, to see that the promise is indeed performed fairly and that the buyer's reasonable expectations as to what he bought are not too rudely disappointed.

What the buyer of insurance is paying for is protection against a certain kind of economic loss for a certain time. Much of the value of the protection comes from the buyer's ability to plan on the basis of it, to use it in enduring commercial relations and to draw from it peace of mind.

All those values are undermined if the insurer cancels at mid-term, through no fault of the policyholder. Statutory policy forms have indeed long provided that the insurer may cancel at any time and for any reason. Yet underwriting techniques and management controls have improved to the point that companies should not suddenly wake up to find themselves overcommitted—or at least should no longer have the luxury of rectifying their error at the sole expense of those to whom they have sold their word.

In auto liability insurance, a public outcry against cancellations brought swift enactment of anti-cancellation laws in many states, including New York, often with broad industry support.

Events of the past year make it appropriate now to extend reasonable protection against cancellation to policyholders in the other personal property and liability lines. It is now clear that only law can establish those uniform minimum standards of conduct which will remove from susceptible managements the temptations to economize in ways that alienate the public from the institution of insurance. Such standards of conduct are in the interest not only of the public but of the vast majority of insurers who underwrite carefully and then stick by their policyholders. A business that sells promises depends, in the long run, on the trust of its buyers.

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Another aspect of the reliability of the insurance product is the guarantee against loss due to insolvency of an insurer. Vigilant regulation can reduce company failures, but no government or private agency has ever devised a foolproof way of insulating any financial institution from insolvency.

Recognizing that despite everyone's best efforts there will be insolvencies, the Federal government (for banks and savings and loan associations) and New York State (for life, workmen's compensation and auto liability insurance), among other jurisdictions, have set up devices for spreading across the industry the cost of saving harmless those citizens who were owed something by the fallen brother.

Is this fair? Are you your brother's keeper? Sometimes, in a competitive economy, he who asks the question slew his brother, and the voice of his brother's dependents cries out unmistakably. But regardless of fault, society has only three places to let the loss fall—on the policyholder, on government and on the entire industry. Of the three the policyholder is probably most innocent and least able to shoulder the misfortune. The general revenues of government would be a fair target, at least for those insolvencies traceable to defects in government regulation, but it is unlikely that the public would accept the exposure without exacting minute control of the day-to-day operations of every company. From society's point of view, then, simple elimination suggests that the industry or, rather, the policyholders of all companies, should share the cost.

The cost of protection, spread among the many, is small; the cost to the individual of having trusted in a worthless policy can be catastrophic.

In New York, we can extend insolvency protection by building upon an existing institution. Our Motor Vehicle Liability Security Fund contains $125 million. Interest alone adds $4.5 million a year, and each year our motorists contribute another $7 million. Yet in the Fund's 21-year existence only $6 million has been drawn out of it, and all indications are that the frequency and magnitude of insolvencies do not increase in proportion to overall premium volume.

The motorists have paid enough, and, without diminishing their protection, we can build upon this unique security fund to extend similar protection to other policies held by these same people and by others. Auto insurance as now written is no more a threat to company solvency than are other lines. A person is no less deserving of insolvency protection behind his general liability policy or his homeowners policy than behind his auto policy.

By simply discontinuing assessments on auto insurance policies, commencing assessments on other lines and broadening the Security Fund to cover all personal and small commercial lines, we can make an immediate improvement in the reliability of the promises sold by insurers to the people of New York State. By providing for all assessments to cease when the Security Fund has reached a specified dollar amount, we can achieve equity as among insurers and can guard against the sterile accumulation of funds in excess of the public need. By providing for assessments to resume if the Security Fund is ever drawn down a specified amount, we can assure that all our policyholders are as fully protected against loss due to company insolvency, at any time in the future, as our auto insurance policyholders are now.

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The third part of helping people get the most insurance for their money concerns their money, that is, the price they have to pay for the insurance protection they buy.

In a national economy that looks to the market to set prices and to allocate resources, property and liability insurance has long enjoyed, or suffered from, a separate existence. Not too long ago, the paradigm of the property insurance pricing system was the cartel. Competition, such as existed, was assuredly not price competition at the consumer level, and elaborate private governments were maintained to make sure it stayed that way.

Like other institutions that rested immobile while the mores of the national economy and the expectations of the public changed about them, these private governments and the cartelized insurance market were overthrown.

The cartels may be dead, but they still rule us from their graves. Our present rating laws were enacted partly to insulate pricing cartels from antitrust attack, partly to impose social control over the practices of those cartels, and partly to preserve inviolate the regulatory jurisdiction of the states.

Government activity which was relevant to conditions twenty years ago, may not be relevant to conditions today. If the institution of insurance regulation is to be able to renew itself from within, we must evaluate what government now does with respect to insurance prices in the light of current market conditions and in the light of the current needs of the buying public.

Since the prevailing rate regulatory laws were enacted, the property and liability insurance business has refined its pricing and underwriting methods, has grown and become more sophisticated, is exhibiting more diversity in price and distribution, and manifests a real willingness to compete in price. While much is still to be learned about insurance market structure and conduct, the structure is propitious for real competition—entry to the industry is easy, concentration is low, sellers are numerous, the product is largely undifferentiated, and total sales are expanding rapidly.

The public has an immense stake in the results of the insurance pricing and rate regulatory mechanisms, but it would seem to have no stake in the form of rate regulation apart from wanting that which yields the best result. What are the results desired of any system of rate regulation? To the buyer, the best pricing system would seem to be the one that yields prices as low as possible, stable prices not subject to large and sudden changes, and prices that are fair as among policyholders. The buyer also gains if the chosen system of rate regulation furthers other public objectives—if it increases, rather than decreases, the likelihood that insurance will be available and reliable.

The system should fit the current realities of the market and should direct our regulatory energies at what actually happens rather than into rituals that bear no clear relationship to reality. Finally, unless it is impractical or against the public interest, our insurance rate regulation should harmonize with general norms for conduct in the economy.

In my judgment and that of my top colleagues in the New York Insurance Department, the present needs of the people of the State of New York would be better served by a rating law which would not prescribe that rates be filed for the approval of the Superintendent. The watchfulness of our skilled examining staff would be directed at what was actually being charged in the field, rather than only at the ritual assertion, in a rate filing, of what a company proposed to charge.

Under this system the forces of competition would be allowed to keep rates down. When cost decreases called for lower rates, the rates could be reduced at once. When cost increases called for higher rates, the rates could be adjusted without delay and hence without even temporary restriction of the availability of insurance. In all cases of aberration—where a rate was excessive, inadequate, discriminatory or destructive of competition—the Department would have full power to suspend or disapprove the rate.

A system of regulation that relies on competition is valid only where competition exists. In any area or kind of insurance in which price competition at the consumer level was insufficient to assure that rates would be neither inadequate nor excessive, the Department should be able temporarily to reimpose prior approval. Such a power would be especially helpful in minimizing dislocations during a transition period and in protecting residual markets. It would also protect the insurance-buying public against any failure of resolve by those in the insurance industry who now profess a desire to compete, but who may merely wish to stabilize their condition on a different and more congenial basis.

In New York, we can expect that a change to more competitive insurance rates will cause some rates to go up and some to go down. We should not anticipate any overall change in rate level as a result of the change in regulatory procedures. The important difference is that rates would be responsive to current costs and markets, instead of being excessive for some risks, which are then overly courted, and inadequate for others, which are shunned and fall into the residual markets.

Those who do not wish to compete in price have conjured many possible evils of open competition. For example, will it lead to rate wars? During the past 50 years, there has been no evidence in California (where rate filings are not required) or in any other jurisdiction that rate competition leads to destructive rate wars. Their memory haunted the Merritt Committee a half century ago, but our own experience and the findings of the most recent Congressional study should lay the spectre to rest.

Similarly, there is no correlation between kind of rating law and the incidence of insolvency, and certainly no evidence that competition leads to insolvencies. If anything, one can infer from recent episodes that rate inflexibility creates pockets of unmet demand that invite the creation of marginal companies prone to fail.

Nor is there any indication that rate competition, given strict antitrust and examination safeguards, leads to higher rates than a prior approval law responsibly administered. Quantitative comparisons between different markets are far from conclusive, but a comparison of loss ratios of like companies in California and New York suggests that rates are similar.

Equally important, experience suggests that more competitively responsive rates lead to greater availability of insurance and to greater public satisfaction with its quality.

We are not limited to a counterfeit choice between regulation alone and competition alone to protect the public. Both are available, and we should use them in combination. To make competition and regulation reinforce each other best in ways relevant to current realities, it is now time to let competition work with less restraint upon the market price of insurance.

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Those four changes—easier access to needed auto insurance, protection against cancellation, security in case of company insolvency, and open competition in rating—will help the property and liability insurance industry serve the public better and will focus our regulatory energies on real current problems.

By the end of the year, the New York Insurance Department will issue a report, refining the four proposals and setting out the documentation for them, so they may be considered at the 1969 session of our State Legislature. Meanwhile, we will seek the views and technical advice of the public, other government agencies and all segments of the insurance industry.

These four proposed changes in the institution of insurance regulation are part of an attempt to keep that institution responsive to current public needs and to current realities within the regulated industry. Even if sound today, the four proposals should be looked upon as adaptations and not as permanent improvements, for that which is devised to be permanent is often, in the long run, no improvement at all.

Regulation is the process of bringing current values of society to bear on current practices of an essential industry, and hence regulation must seek relevance more than permanence. If we in government keep in mind, in simplest terms, what our goals are, we will be best able to pursue those goals relentlessly.

If the limited resources of public attention and government power are to do the most good in insurance regulation, they should be directed at helping people get the most insurance for their money. Our efforts can be measured by how they affect the availability, reliability and price of insurance. If we can orient our complex and venerable institutions to those simple, current goals, we will renew them from within, and they will endure—and deserve to endure—when their rituals are forgotten.

The End of Isolationism in Insurance Regulation

Your corporate ancestors knew the quiet pleasures of tradition, uniformity and deliberation, of the measured step and of being let alone. Stability was their natural condition and steadfastness their manly virtue.

Those pleasant, past days were not for you. Instead, you have come through two careening decades in the pricing, marketing, corporate structure, underwriting and law of insurance. For you, change has been the natural condition and steadfastness now answers to unkinder names.

The certain prospect is for the future to accelerate its flight from the past. Memory will remain a cherished entertainer but will become a more and more treacherous guide. We need to look anew at where we come from and where we may be going, if we could choose to steer the organizations we are, in any event, fated to ride.

Where have we come from? From a past in which the property and liability insurance business was isolated from the rest of the economy and from the polity—isolated by its constitutional history and accounting conventions, by the complexity of its product and pricing, by the singularity of its distribution channels and securities markets; isolated in dialect and heritage; immune from intruding products of adjacent industries.

Isolation is comfortable. Its environment is familiar and under some control. It prompts few crises of identity and little anguish about the worth of one's work. How satisfying to be sure that no one understands us but ourselves.

The comfortable isolation of insurance from the main rules and assumptions of the private economy was confirmed by its being regulated by government. Insurance regulation had its own inward-looking tradition, a defiant autarchy of ideas whose first resource was the very uniqueness of the insurance business. Our strength was in making legitimate and secure your isolation. How reassuring to be sure no one understands our trust but we ourselves.

Your isolation is breaking down. The old serenity has gone to dust already. People outside are no longer letting you alone.

* * *

Annual Meeting, American Insurance Association *New York, NY* *May 29, 1969*

The insurance business, then, is unmoored from its past, but where is it heading? Heretofore isolated from the rest of the economy and the polity, insurance will hereafter move toward the one or the other.

If, in the future, the insurance business lives more by the rules of the rest of the economy, and the public believes it is doing so, the public will tend to treat the insurance business more like other businesses. If the insurance business does otherwise, the public will tend to treat it more like an extension of government—demanding fuller public accountability for its actions and wider public representation in its revenue raising, and resting indifferent when its functions are absorbed by government. The people will in no case leave you alone, for everywhere the people are casting fire and bile at institutions that claim uniqueness, inscrutability and isolation, while claiming as well the people's money or allegiance.

The economy and the polity are the only two visible destinations for the insurance business. Which one, or which point between, will be reached is not predestined and not resolved. There are choices to be made, and time for men at home with change to make them. The outcome is not clear. But there are signs already.

The signs are in the business and in regulation, but not wishing to appear more fluent about your situation than my own, I shall discuss changes in regulation—but changes that may suggest a direction in which not just government but the insurance business as well is moving.

The regulatory changes are taking place in many states, but two recent changes in New York are typical and are suggestive of the direction. The two New York changes are the legislation on holding companies and the four-part legislation on the assigned risk plan, cancellation, insolvency guarantees and competitive pricing.

The two new laws suggest that the norms of conduct of the property and liability insurance business are, with the encouragement of government, moving toward the norms of the rest of the economy. Here is why.

The holding company law acknowledges the legitimacy of cautious diversification by insurance companies into the rest of the economy. It also establishes rules of conduct for insurers that are affiliated with firms in the rest of the economy. The rules are directed at security requirements of insurance which are validly regarded as unique, and at preserving that security against abuses to which control situations lend themselves.

Significantly, the law attempts to regulate the conduct without outlawing the structure. This kind of law is an alternative to isolationism, both because it lets

insurers do more on their own initiative and because it permits the insurance and non-insurance economies to live together within rules that may break the historic holding company cycle of euphoria, gluttony, revulsion and neo-isolationism. That this cycle otherwise lies ahead is clear enough from evidence in the archaeology of finance that the pyramid is rarely far from the tomb.

The four-part law sets rules of availability, quality and pricing that can bring insurance market conduct closer to the norms of conduct elsewhere in the economy.

In a consumer economy where nearly all products are equally available to willing buyers with the price, the four-part law strengthens a mechanism for making available an essential kind of insurance. In a consumer economy where manufacturers, at immense embarrassment and expense, are acknowledging the duty to recall their product due to defects in the product, the four-part law restricts the privilege of insurers to recall their product due to perceived defects in the buyer. In a consumer economy where the quality of the product is not affected by the seller's subsequent misfortune, the four-part law guarantees the worth of the promise sold even if the seller disappears.

Finally, in a consumer economy where competition is expected to set prices, the four-part law puts aside regulatory habits borrowed from the utility and called forth by the cartel. It is designed for an industry in transition toward greater price competition at the consumer level and toward more informed and responsive markets, and so it combines regulatory provisions with provisions for encouraging competition. But seen against the history of pricing in insurance, the move to a competitive rating law, although safeguarded, is a major step indeed.

The move by New York may be especially significant and especially difficult, for the more detailed, thorough and restrictive a system of regulation, the likelier both the regulator and the regulated may be to look upon the industry as unique and upon the regulatory system as a substitution for forces operating elsewhere in the economy. To administer a new competitive rating law in keeping with its spirit will demand that we in government change our habits and keep in mind the intended direction of the change.

Something of the sort may also be required of you in business. The initial responsibility for pricing your product will be yours alone, and the comforts of the old partnership with government will be withdrawn. Freedom in a field of free competitors may hold fewer sure delights than an isolated constraint partly of one's own making. Talk of freedom may come less easily when one is at last condemned to be free.

* * *

On the whole, the move of insurance toward the rest of the economy is hopeful for the industry and government and, most of all, for the public.

Much regulation was first called into being where government was the only responsive link between the individual and the seller, where government offered the citizen his last hope of bringing the conduct of a powerful but deaf institution more into line with his needs and expectations.

While regulation is one way, however imperfect, for the public to enforce its expectations, a healthy competitive economy is another way. Having derived his expectations about businesses from his dealings in the rest of the economy, the citizen and consumer will find insurance most like his expectations, and hence most satisfactory, if it behaves like the rest of the economy. The behavior of the rest of the economy can certainly stand improvement, but the citizen-consumer, and in the long run the insurance business, will hardly find insurance more satisfactory if it tries to hold aloof from the general standards.

The early and encouraging signs, then, are that the property and liability insurance business, its isolation ending, will move toward the rest of the economy. It is the direction of our change; our arrival is less certain. Too often, between the design and the actuality falls the shadow.

Instead of what we foresee, there may never be an end to isolationism in insurance regulation, and today's portentous acts may be mere twitches as torpid industry and sightless regulation muffle the impact of events. Or the isolation may be ending, but the eventual movement of insurance may be toward government rather than toward the private economy. But I doubt it.

The shift in the regulatory environment is real, and comes at a time when other forces are also pushing insurance toward the rest of the economy. The insurance business has at least a first refusal on that one of the two visible destinations. The choice is with you—the first generation of insurance executives accustomed to change—and you are best able to see with a long eye what the choice means.

The Wages of Fear in Insurance Regulation

In their trust and inattention, the people have left regulation to their lawyers—in the legislatures, the agencies, the businesses, the bar and the courts.

The lawyer-like regulatory systems exhibit qualities and flaws not unknown in the parent profession. They are moral and preachy, careful and slow, professional and inbred, studious and detailist. They are judicious, and they make decisions instead of policies.

Most of all, the systems of regulation proceed from the ideas that the regulated industry is different enough from its surroundings to call for special attention, and that the impulses of the industry require the restraining constancy of law. As these ideas work their human way toward excess, they come to validate the comfortable assumption that the industry is unique and immutable, and must be isolated into its own frozen world of special laws and guardians.

These qualities of regulation, good and bad, have helped produce the insurance holding company, are tested by it and are everywhere reflected in its history. The history has three phases, which began at different times but continue today.

At first, holding companies were a way of making it easier to do an active insurance business.

A retailer believed his customers were frugal and hence good risks, and so the retailer used a subsidiary insurance company to put a new product in the store. A fire insurer, in the days before multiple-line underwriting, wanted its agents to offer casualty insurance as well, so it set up a subsidiary, just as life and property insurers are doing in each other's fields today. A life insurer wanted access to the market in a state, but did not want to shape its entire operation to that state's laws, and so it planted a local subsidiary. An auto insurer wanted to write sub-standard risks without tarnishing its image, or wanted to experiment in marketing without alienating its agents, and the answer was an affiliated corporation.

These examples suggest why the holding company has, in the past, not been much of a problem to insurance regulation. It was in the hands of people who wanted to do an insurance business, and regulation presupposes that the people in the regulated business want to be there. While the holding company was often used

to evade the spirit of regulatory laws, it served as a safety valve for the release of economic forces that would have broken through in any event.

A few years ago, the dominant motive for forming holding companies changed. The impetus still came from within the insurance business, but the new motive was not to facilitate the doing of that business. On the contrary, it was to diversify away from the conventional insurance enterprise. Life insurers, construing broadly their purpose of selling financial security, used affiliated corporations to offer variable, inflation-resistant products. Property insurers, unprofitable in their insurance operation, sought to diversify into adjacent fields or to disinvest and move assets where the yields were higher.

The goal in this second phase of the insurance holding company was flexibility, real or imagined. It coincided with the rise to top management of many companies, for the first time, of men whose background was not in sales or underwriting, but in investment. These men wanted to use the resources of their insurance companies—money, reputation, financial skill, agency forces, customers—to achieve more profit and honor than they foresaw in the conventional insurance enterprise.

In this second phase, the new motives for forming holding companies are the key to the new concern of the regulators. Management wanted to move money and talent away from the classical insurance business, to wander off from their entailed duty station. Thereby they subtly affronted the regulators and openly defied the presumptive constancy of regulatory law. Beyond the insult was the challenge. Regulators commonly see it as their role to follow with special care and apprehension any new activity of the regulated industry, and the recent holding company movement threatened to have the regulators responsible for activities they did not know much about.

The third phase in the history of the insurance holding company was like the second in having flexibility as a goal and a breakdown of the isolation of insurance as a consequence. Yet it was of a different magnitude of unconventionality and far more alarming to the insurance business and its regulators, for in this phase the impetus came from outside. The third phase is sometimes thought of as the invasion of the conglomerates.

The invasion was resisted by insurer managements because it presented a direct threat to their prestige and even their tenure, and because the invasion was mounted upon the insulting ground that scientific management from outside could make insurer assets yield more than could seasoned insurer managements. The regulators resisted the invasion partly because they were mobilized by the industry and partly because they feared, not without reason, that the integration of insurance with unregulated businesses and the dominance of general entrepreneurial values

over the traditions of insurance would place heavy strain on the established regulatory system.

For the moment, the public, the industry and the regulators are bewitched by the vivid and understandable—the drama of takeovers, the legerdemain of growth by acquisition, the daredeviltry of leverage and the barbarities of corporate plunder. But what now fascinates us most is least likely to endure. Regulation can, should and doubtless will bring under control the zanier antisocial proclivities of the insurance holding company.

A special study in New York concluded that conduct within such a holding company structure could be regulated, and probably at the state level, if government kept insurer diversification within limits and concentrated regulatory energy on the points of contact between insurers and their non-insurance affiliates, where abuses such as milking and conflict of interest can best be identified, quantified and subjected to familiar regulatory techniques. Very likely, laws like the one passed this year in New York will enable the regulators to prevent the abuses we have foreseen and to keep abreast of the invention of new ones.

Should we go further? Surely, it is well within our power and our habit to shore up the isolation of the insurance business, on the ground that only in quarantine can the business be stable and well regulated. Rightly concerned about conduct within a holding company structure, government can outlaw the structure itself. Someday that may have to be done, but it should only be done as a last resort, only if the regulation of conduct proves impossible. Regulatory convenience and insurer tranquility are not reason enough.

In its three phases, the insurance holding company has served different purposes. It has not always been good, nor has it always been bad. Regulators do not need to hand down a simple decision, a definitive and universal ruling, on the insurance holding company. We need intelligent regulatory policies, and we are getting them. But if we cannot judge the insurance holding company, we can certainly learn from it.

If an insurance executive discovers that knowing he is to be raided in a fortnight concentrates the mind wonderfully, he might heighten his standards for quieter times. If an insurance executive finds an attacker's claims for scientific management to be difficult of refutation, he might well question the sanctity of inherited methods. If an insurance executive is embarrassed when held, by those he fears, against a pitiless external standard of efficiency, profit, growth and responsiveness to customers' needs, he might well ask whether his misfortunes are entirely beyond his control.

The regulators of insurance—their heritage enmeshed with industry's, their destiny obscure—also might well inquire for the lessons and portents of the insurance holding company.

If a regulator discovers holding companies coercing subsidiary insurers to meet yearly profit targets, he might re-examine his techniques for detecting the manipulation of accounts and the borrowing of future profit for present display. If a regulator fears that holding companies may vampire upon insurers, he might well ask if his traditional ways of regulating for solvency still offer policyholders enough protection. If a regulator finds that a pervasive commercial ethic discourages insurers from performing uneconomic but socially useful functions, he might well check the old tools for easing frictions between insurers and individuals and for repairing general failures of the insurance mechanism to meet public needs. If a regulator fears the holding company will overtax his resources, he might contemplate how efficiently he deploys the resources he has.

The signs are that the public can protect itself against holding company abuses without exiling insurance from the rest of the economy. It is the more complex and uncertain solution, but it offers to the business and the regulators the rewarding agony of questioning established ways and of confessing they can learn from what they fear.

The popularity of the insurance holding company has often in the past signaled that the established order, in business and government, was not responding to a new expectation. A regulated industry and a regulatory system that welcome such warnings can turn them to advantage and can take from fear its good fortune.

Pressure and Results in Insurance Regulation

Early next month, the New York Insurance Department will submit to Governor Rockefeller a report on automobile insurance.

The report will try to look at the system of handling automobile accident costs as a system, and to measure its overall results against the standards which society ought to have for so important an institution.

While hardly an original approach to economic and social questions generally, this emphasis on objectives and on the overall results of a whole system is quite outside the tradition of insurance regulation.

For a long time, the regulation of insurance, like the regulation of other kinds of business, has been concerned with parts and not entireties; with rules, procedures and mechanics, not with objectives and results.

We have so spun our laws and precedents as to have determined to the uttermost nicety how we want the minutest part of the insurance business to behave. But we know so little about what we want private insurance as an institution to accomplish.

While baffling the average man with our mastery of what he cannot understand, we have often left him with the impression that we do not care enough about what he does understand—and what he understands is results.

This is changing. In insurance regulation and in some other fields, government is becoming less and less satisfied to measure the industry's performance in the traditional terms of its adherence to rules and its condition, decency and diligence. We are entering upon a period when regulators more and more will measure the regulated industry in terms of its overall product or results.

The change is coming about in insurance perhaps more rapidly than elsewhere. The reason is not that we are more alert but that we—both the business and the regulators—are more vulnerable. We are becoming responsive because we are becoming aware that our existence is precarious. How so?

The insurance business is awakening to the full significance of being in a line of work in which government also has a certain talent and experience. Federal and state governments today operate or control many mechanisms for transferring

money and distributing risk that once were the exclusive province of private insurance companies. And the governments operate other mechanisms that are not thought of as insurance due only to the way we think about insurance.

When enough citizens want to distribute through the community some risk of living, and find the private insurance business not offering a good way to do so, those citizens will turn to the next most logical place. Then the insurance business usually finds itself alone. Other businesses rarely stand with it. More often, their essential interests are adverse to those of the insurers. Sometimes it is the other businessmen who lead the cry for government to come in.

Government indeed comes in where private business drops out, but once in government may go further. No one, and certainly no sovereign, should be expected to conceive his mission as nothing more than picking up after someone else.

But it is wrong to suppose that government moves in on the private insurance business where it is organizationally convenient for government to do so. Government does not move in on functioning private entities just because they are easy to grab. Government moves in when the private entities are not functioning, where an insistent public demand is not being met by private enterprise. Government takes over, not because it has a master plan or because it thinks it can do the job better, but because it thinks it has to.

Government responds to public pressures; it does not scheme. It is inherently political, not inherently socialistic.

Now if the insurance business is finding its existence so precarious, what about the state regulators? If anything, they are more precarious, more threatened and besieged, less certain to survive.

The state regulators of insurance are awakening to the full significance of being in a line of work that exists at the sufferance of the federal government. One act of Congress could take away our jurisdiction. Committees of Congress and offices in the executive branch are continually probing the quality of state regulation of insurance, shaming it publicly for its failures, and admonishing it to do better on pain of extinction.

The record of the federal government in the regulation of business is wildly uneven, as is that of the states. But whether the federal government could regulate better than the states is not the point, just as whether government can run a fund-transfer mechanism better than private enterprise is not the point.

The point is that the federal government has the right and the duty and the need to oversee the performance of the state regulators of insurance. If the state

regulators exist by the will or abstention of the federal government, then the constituents of the federal officials are entitled to hold those officials accountable for the results of state regulation of insurance, which largely means for the overall performance of the private insurance business.

The federal officials respond to the pressures and discontents of the citizenry. They do not plot to gobble up the jurisdiction of unwary state regulators. They have all the jurisdiction they can handle, and they are not so foolish as not to know it. They do not scheme, but they do respond. The federal government is inherently political, not inherently expansionist.

Few individuals and no organizations are so energetic and so saintly that they do not need watching. We do better when we know someone else will evaluate our work. We take his evaluation most seriously when we know he has the power to wipe us out.

Both the insurance industry and the state regulators of insurance are blessed with that kind of deadly supervision. And of the two the regulators are more forcefully blessed, for if few outsiders care about the survival of the insurance business when government intervenes, imagine how few would mourn a regulatory agency.

Both the insurance business and its regulators are awakening to the precariousness of their existence. Perhaps we will draw from our insecurity new energy and awareness. Perhaps we will come to understand that the fellow looking over our shoulder is himself subject to pressures, and that the strongest pressure is from the public and is a pressure for results.

The public does not have the patience to trace the convolutions of our system or to master the intricacy of its malfunctions. The public wants results, and it wants results now. The public does not want to hear about our troubles. It has its own troubles, and sometimes we are one of them.

Many modern institutions are hard for the public to get a grip on. But not insurance and insurance regulation. More and more the public is sensing that in insurance, and in some other fields deeply affected with the public interest, it can demand results and can watch with satisfaction as that demand is passed down the line by people whose displeasure can be fatal to the business or the regulator or both.

All this is to say that insurance and insurance regulation are two contemporary institutions that are becoming more responsive, in which the individual citizen is gaining rather than losing power over the decisions that affect his life. All this is to suggest that regulatory agencies, in insurance and in some other fields, will come in the future to evaluate the regulated industry, just as they

themselves will be evaluated, more in terms of the ultimate results of the whole operation than in terms of sub-structure, process, docility or intent.

Being held accountable for results, and being so held by people who can write or erase our future, will not be comfortable for either the insurance business or the state regulators of insurance. It will be demanding, but quickening, and it means that, if we come through at all, we should come through in very good shape indeed.

Perhaps what is coming now for regulated insurance is coming soon for other businesses. The public, and its governments, may generally come to look more to the results produced by private institutions, and to look less to their traditions, motives and adherence to rules. Perhaps we are seeing it first in regulated business, where the public can naturally expect to be heard. And perhaps we are seeing it first in those corners of regulation that are most precarious, where the business and the regulator have most reason to fear the consequences of not paying attention.

What insurance and insurance regulation are about to go through—the public demand for results unsoftened by an appreciation of procedure and tradition—may presage what awaits other businesses. And if only in the laboratory sense, the good health of private insurance and state insurance regulation may be of interest to us all.

Automobile Insurance Reform

In response to the Committee's courtesy in inviting me to lead off at this hearing, I should like to describe the history and content of the Insurance Department's report on auto insurance, and then to touch upon a few other questions. My testimony will be brief, but several of us from the Insurance Department will be available throughout the hearing to answer questions.

Background

In 1967 Governor Rockefeller appointed a Committee on Compensating Victims of Automobile Accidents. The Committee was chaired by former Judge Van Voorhis of the Court of Appeals. The members included representatives of civic, labor, professional and consumer groups and government agencies. The Governor charged the Committee to study the present system of handling automobile accident costs and of compensating automobile accident victims, and to make recommendations for improvement.

In the deficiency budget for 1967-68 the Governor requested $50,000 for the initial expenses of the Committee, and in the state purposes budget for 1968-69 the Governor requested $300,000 to finance the full study. No funds were ever appropriated for the Committee. After intermittent efforts to carry on its work anyway, the Committee unanimously voted in the summer of 1969 to disband.

In acquiescing in the Committee's decision to disband, the Governor designated the Insurance Department to carry forward the study.

The Insurance Department's work was based principally on the large and impressive body of published material on automobile accident reparations; on the records of the VanVoorhis Committee; on a study of closed claims made by our examiners; on new analyses of existing data by our actuaries and statisticians; on new data furnished by the U.S. Department of Transportation; on responses to a request for comments which we issued to all members of the Legislature, other community leaders and the general public; and on the advice of a panel of leading scholars of accident law and automobile insurance.

The Department's report, entitled "Automobile Insurance...For Whose Benefit?", was submitted to the Governor on February 12, 1970, and released by him on February 16. Implementing legislation was submitted by the Governor on March 6, together with a special message urging enactment of the legislation at the session

of the Legislature then in progress and now recently adjourned. The bill was not, however, reported out of committee in either house.

The Insurance Department's report has been a public document for two and a half months; it was widely and ably reported in the press and other media; and 20,000 copies have been given out. Copies of the report, of an actuarial supplement to the report, of the implementing legislation, and of the Governor's statements on the subject are all available at this hearing. Accordingly, I shall not belabor the Committee with a detailed recital of what is in those documents, but I should like to summarize a few of the more important points.

Failures of the Present System

The report reviews at length the record of the present system of handling the costs of automobile accidents. The two main constituents of the present system are, first, the common law of liability for negligence or fault, and, second, liability insurance. Hence we have called the present system the fault insurance system. I should like to review with you some of our conclusions about the fault insurance system.

(1) **Slow Payment**. The Insurance Department's report finds the present system to be slow in paying benefits to automobile accident victims, a slowness that causes financial hardship and impedes rehabilitation. The average victim has to wait more than a year for a liability insurance payment—forty times as long as it takes him to collect on accident and health insurance. The victim who has to sue encounters court delays up to five years in the urban and suburban counties of this State. The human situation is even worse than these statistics, for the more serious the victim's loss the longer the delay.

(2) **Unpaid Victims**. The Insurance Department's report finds that the fault insurance system denies compensation to many victims. One out of every four people injured in an automobile accident collects absolutely nothing from the system.

The reason is that the law of negligence, which governs the right to recover liability insurance benefits, requires the victim to prove that someone else was exclusively at fault. This means the victim cannot get paid unless he can prove someone else was to blame. Even then, the victim gets nothing if he himself was, to the slightest degree, negligent or at fault.

This rule of the fault insurance system—that payment turns on proving someone else exclusively at fault—has large consequences, not only for the one in four who is left out entirely but also for everyone who has to deal with the fault insurance system. So let's digress to look at that rule for a minute.

Of the major lines of personal insurance, auto liability is the only one that makes you prove some stranger was exclusively at fault before you can collect from the insurance company. There is no such gauntlet to run in life insurance, health insurance, fire insurance, theft insurance or even in automobile collision or comprehensive insurance. Imagine how strange it would seem if the rules of the fault insurance system were extended there.

When you are ill you want your health insurance to pay your medical bills without requiring you to prove that your illness was caused by someone who carelessly sneezed on you on the bus. Nor would you tolerate a health insurer which sought to duck payment by claiming you would not have gotten sick if, right after the sneeze, you had run home and gone right to bed. Yet that kind of proof and that kind of defense are the mainstays of automobile insurance today.

(3) **Overpayment of Small Claims**. The Insurance Department's report finds that the present fault insurance system pays the claimant with a small loss far more than the accident cost him. This is not a new finding. The same conclusion has been reached in study after study. Nor is it just an old finding, for the preliminary data from the U.S. Department of Transportation's extensive, current study of claim files shows that three out of every four New York claimants with economic losses under $200 got paid more than double their economic loss through the fault insurance system.

The overpayment of these small claims, while called "pain and suffering" by lawyers and insurance men, typically bears no relationship to actual pain or actual suffering. It has a simpler explanation. The standard of liability and the measure of damages in automobile liability cases are vague and uncertain, leaving wide latitude for bargaining between the victim or his lawyer and the insurance adjuster. Only one percent of claims is decided by a court; the rest are bargained. To an insurance company the typical small claim has a nuisance value. The claim is overpaid to get rid of it.

The overpayment of small claims under the fault insurance system might be unobjectionable if the payment were not passed along to consumers as higher insurance rates. But in fact these overpaid small claims cost consumers dearly. An estimated 25% of all auto liability insurance awards go for payments in excess of economic loss to victims whose economic losses are under $1,000. And as we shall see, every dollar of claim payment costs $2.25 in premiums.

(4) **Underpayment of Large Claims**. The Insurance Department reports finds that the present system deals far less generously with the seriously injured victim. When you cut through the rhetoric of the defenders of the present system, a rhetoric heavy with solicitude for the seriously injured, you confront the shocking fact

that victims with large medical costs and wage losses do not recover from the fault insurance system even the full amount of their medical costs and wage losses.

Again, the Department's finding is not new. The underpayment of the seriously injured was revealed by a Columbia University study in 1932. The finding was confirmed by a leading study six years ago. The most recent, as well as the most dramatic and best documented, finding as to the underpayment of the seriously injured is in the voluminous national survey of serious injury cases released yesterday by the U.S. Department of Transportation. That survey found that the seriously injured traffic accident victim or his survivors were compensated, from all sources, for less than half of their actual economic loss; and that auto liability insurance contributed less than one-third of the reparations that were made—or one-sixth of the economic losses of seriously injured victims.

The reason for the underpayment of large claims is simple and is the corollary of the reason why the present system pays too much on small claims. The typical large claim is underpaid because the seriously injured victim cannot wait for his money and can be bought out cheaply.

The fact that the present system underpays the seriously injured is a fact of the utmost importance to any government with a humane and progressive tradition. It is a fact that is often obscured by rhetoric and by the occasional spectacular award. The occasional big award illustrates nothing more than that any lottery pays off sometimes. But the real news is that day in and day out the fault insurance system is shortchanging the very people who need the money most.

If government has compassion, if government has the heart to respond to unorganized need and inarticulate misery, then those facts—and make no mistake about it, those are facts—cry out for reform more eloquently than any report or any testimony.

(5) **Waste**. As if the failings already mentioned were not enough to discredit the present fault insurance system, the Insurance Department report goes on to trace what the system does with the consumer's premium dollar.

Over half of the money paid into the system goes to the overhead expenses of the system. And a very large proportion of what gets through the machinery is, as I just discussed, misallocated, with too much going to small claims and too little going to large claims.

Specifically, the report finds that 56 cents of each premium dollar is kept by the insurance companies, insurance agents, insurance adjusters, plaintiff's lawyers and defense lawyers who operate the system. Of the 44 cents that go to victims as a class, 21½ cents go for other than economic loss, typically in overpayment of small

claims. Another 8 cents go to pay over again economic losses that have already been compensated from another insurance source such as health insurance. That leaves only 14½ cents out of the premium dollar to pay for the net economic losses of the victims of automobile accidents.

That kind of waste might be tolerable—indeed the facts have been known and tolerated for a long time—if auto insurance were cheap. Once it was cheap. But no longer.

Today the average cost of the auto insurance which New York law compels every car owner to buy is $125 per car per year. Today the typical car owner, who rightly decides that he has to buy more insurance than the law requires if he is to protect himself, pays $250 per car per year for automobile insurance. If he drives for forty years, he can figure on paying $10,000 for auto insurance during his lifetime, and that is at today's prices.

But the price of auto insurance has been going up—95% since 1950. At least as long as inflation continues in the general economy, the prospect is for the price of auto insurance to continue to go up.

With the price of auto insurance high and rising, waste and inefficiency in the auto insurance system become less and less tolerable. The Insurance Department report predicts that the waste and inefficiency of the fault insurance system would be enough to doom the present system some day even if there were nothing else wrong with it.

(6) **Duplication of Other Insurance**. The Insurance Department report finds that the premiums which consumers pay into the fault insurance system often go to pay duplicate benefits.

Many auto accident victims are entitled to payments from such sources as health insurance and income continuation plans. But under the "collateral source rule" of the fault insurance system, these other benefits are disregarded in setting the amount of a liability insurance award.

In a state like New York, where health insurance and wage loss insurance are very widespread and auto insurance is universal, the result is that a lot of people are paying duplicate premiums to support duplicate benefits. But duplicate benefits are a bad buy, remembering that every dollar in auto insurance benefits costs $2.25 in premiums.

One person who is penalized the worst by the present arrangement is the employee with good fringe benefits for health care and loss of income. Were auto insurance not a liability system with a collateral source rule, this employee could see

his progressive fringe benefits reflected in an immediate lowering of his auto insurance premiums. But today, no matter how progressive his fringe benefits, the employee's auto insurance premiums are unaffected. All he gets is a chance at redundant benefits if he is injured some time in the future, and redundant benefits are a bad buy.

If a person wants to pay twice, he should be free to do so. But why should his own government compel him? No one is saying it is not nice to get double benefits. The point here is that it isn't free. Premiums are not so low, nor people so rich, that the law should make anyone pay more than once for protection.

(7) **Traffic Safety**. Last year the automobile killed 56,000 Americans. That is more American deaths in one year than in the Vietnam war since its beginning. Last year the automobile injured 4.6 million other Americans. That is four times the number of Americans wounded in all of World War II.

Against that gory background, some defenders of the fault insurance system still insist that the present system somehow deters unsafe driving. That is nonsense. The Insurance Department's report points out that under the present system the standard of legal fault is vague; determinations of fault are made long after the event; the extent of liability is in no way proportional to the degree of carelessness; the liability is not just of the driver but of the vehicle owner whether or not he was driving; and, most important, the liability is insured against.

Automobile liability insurance is compulsory in this State. The wrongdoer, assuming there is one in an accident and his fault can be proved, does not pay. The insurance company pays. Through premiums, we all pay.

Neither reckless driving nor last-moment mistakes—undeterred by fear of death, injury, imprisonment, fine or loss of license—can possibly be deterred by fear of civil liability which is covered by liability insurance. The contrary belief would be nonsense and, if people really believed it, dangerous nonsense, because we would be trusting for our safety in a system that cannot help.

(8) **Other Criticisms**. The Insurance Department's report also criticizes the fault insurance system on other grounds—pointing out how it encourages overreaching and dishonesty, how it clogs the courts, how it renders the insurance mechanism unstable and prone to breakdown and anti-social conduct, and, finally, pointing out how the present system is socially and economically regressive, with underwriting, rating and claims practices that penalize most the young, the old, the poor, the different, the unsophisticated.

Now, if the foregoing are some of the defects in the fault insurance system, what is the cause of the defects? What kind of change is necessary to get at those defects?

Why the Present System Fails

The Insurance Department report traces the operating defects in the present system to the system's most fundamental principles and to an irreconcilable conflict between those principles.

The present fault insurance system is based on the common law of negligence or fault. The law holds that a person who has suffered a loss can recover damages from another person only if he can prove that that other person was exclusively at fault and can further prove that the faulty act was the cause of the loss.

The legal rules, which antedate the invention of the automobile, were not designed to compensate accident victims. They were designed to make wrongdoers pay for what they did.

The purpose of the legal rules has been undercut by the development of liability insurance, which every car registered or driven in this State has to carry. Liability insurance is designed to do nothing more than reimburse wrongdoers for what they might have to pay for negligently causing damage to another. If the law of negligence is designed to make sure wrongdoers pay, liability insurance is designed to make sure wrongdoers never pay. In this conflict, liability insurance has prevailed. It has rescued the wrongdoer. It assures that any cost which the law would shift to a wrongdoer shall be immediately lifted from him.

But if liability insurance has undercut the law of negligence as far as it concerns making wrongdoers pay, the law of negligence has prevailed in determining which victims shall be paid. The law of negligence lets the victim collect from the insurance company only if the victim can prove that the insured was exclusively at fault.

It is no wonder that such a system fails both the accident victim and the insurance consumer, and it is of the utmost significance that the failures of the present system are traceable to its most fundamental principles.

Over the years, New York and other states have repeatedly tried to patch up one or another of the defects in the fault insurance system without challenging its fundamentals. An important finding of the Insurance Department's report is that such steps will not in the future yield useful results. After analyzing such palliatives as small claim arbitration, supplemental first-party benefits and comparative negligence, the report concludes that "further attempts to modernize the fault

insurance system by tinkering with it, while leaving its essentials intact, are sure to be expensive and self-defeating. The operators of the present system would just be buying themselves time with other people's money."

The Need for Fundamental Change

The defects in the present system are indeed fundamental. The key to real improvement is fundamental change. The essence of sound, fundamental change has to be (1) the discarding of case-by-case determinations of legal fault as the prerequisite to payment, (2) the replacement of vague and indeterminate measures of damages with clear and objective measures of compensation, and (3) the elimination of the conflict of purpose between accident law and accident liability insurance.

The Department's report discusses what we believe to be the criteria for a fair, humane and efficient system of compensating the victims of automobile accidents and distributing the costs of those accidents. From the criteria the report develops and sets out in detail a proposal for fundamental reform of our automobile insurance system.

A Proposal for Fundamental Change

The proposal would abolish negligence law claims and lawsuits based on the operation of motor vehicles in this State. It would require that every vehicle owner carry insurance to protect the occupants of his vehicle and pedestrians hit by his vehicle. Insurance benefits would be payable without requiring the claimant to prove that anyone else was at fault. The compulsory insurance would pay full compensation to all victims for net economic loss resulting from personal injury, such as medical expenses and income loss, or resulting from damage to property other than automobiles.

The proposed compulsory insurance would pay considerably more in cases of serious injury than does the present one. It would pay faster, with less haggling, and its benefits would be paid periodically rather than in a lump sum — all qualities that would help the victim get the money and the care he needs when he needs them.

It is useful to note that while the proposed compulsory insurance would provide generous benefits, it would compensate only for economic loss and only for that economic loss not already compensated by some other, more efficient kind of insurance. The reason is simple. We are talking about compulsory insurance, about the coverage that everyone is required by law to pay premiums for. In our judgment, government should exercise that kind of compulsion on its citizens with restraint.

But as the report indicates, and as I emphasized in testimony on March 10 before the Assembly Insurance Committee, the Legislature would always be free to change the level or types of benefits provided by the proposed compulsory insurance. For the proposal would set up an insurance system that would be amenable to rational decisions by the makers of public policy as to the best balance of costs and benefits. The changes from fault law to compensation, from vagueness to precision in measures of awards, from insurance for strangers to insurance for yourself, from waste to efficiency, from complexity to simplicity—all are basic to real reform. The level of benefits and the consequent level of premiums within a reformed system are not basic, but would be proper subjects of continuing legislative review.

For example, while we have recommended that a reformed system provide unlimited compensation for net economic loss, the Legislature might reasonably decide to set limits on that compensation in order to hold down premiums for the compulsory insurance. In the other direction, while we have recommended that compulsory insurance under a reformed system cover only net economic loss, the Legislature might reasonably decide it was worth the extra premiums to include, in the compulsory coverage, benefits for certain objective though non-economic consequences of an accident, such as dismemberment or loss of function. Such non-economic loss could be compensated within a reformed system far better than it is today. It is to be distinguished from what is also called "pain and suffering" under the fault insurance system but which is just the bargained over-payment of small claims.

The best level of benefits, and consequent level of premiums, within any compulsory insurance system is, of course, a matter for debate and for careful government decision. The point is that in a fundamentally reformed system the Legislature could make those decisions and could be confident its decisions would be implemented efficiently and applied even-handedly to all citizens however situated. That is impossible under the fault insurance system.

We have been talking about compulsory insurance, but it is useful to keep in mind that consumers would remain free to buy additional coverage if they wished. Four out of every five people injured in an automobile are members of the car owner's family. Under the proposal, the car owner would be buying insurance largely to protect himself, his family and his car. He would be in the best position to decide what he needed and what he could afford.

The proposal would reduce premiums substantially, both as to compulsory coverages and as to the combination of compulsory and optional coverages which the typical motorist might be expected to buy. The consumer would see less of his premium dollar eaten up by the operating expenses of the system. He would see a fairer share of his premium dollar going to pay for net economic loss—57 cents as

against 14½ cents today. The consumer would know his premiums were supporting benefits mainly for himself, his family and friends, rather than mainly for adversary strangers.

The Insurance Department's actuaries estimate that the proposed compulsory insurance should cost the average consumer about 56 percent less than compulsory automobile insurance costs him today. For the typical driver who buys additional coverage today on an optional basis, comparable coverage under the proposal should cost 33 percent less. These cost comparisons are based on the best available actuarial data and on conservative assumptions, although, as the report emphasizes, they are, of necessity, estimates. But it would hardly be in the interest of a regulatory agency, which would have continuing responsibility for any new system, to exaggerate its estimate of premium savings.

It is important to note—and this has frequently been misinterpreted—that the estimated premiums for the proposed compulsory insurance include not only the basic coverage for net economic losses of occupants and pedestrians for injuries in New York accidents, but also include liability insurance, at today's levels, for out-of-state driving and for wrongful death. For the typical driver who has optional insurances too, the estimates for the proposal also include collision insurance. Finally, it is important to keep straight that the proposed change in auto insurance would have no effect on the rates charged for health insurance, disability income insurance or any other coverage which would be primary to auto insurance. Those insurances pay auto accident victims today and they would continue to do so under our proposal. The difference is that our proposal would eliminate duplicate payments, which is one reason it would bring auto insurance premiums down.

The fault insurance system protects careless drivers better than accident victims. It does not and cannot deter unsafe driving or otherwise promote highway safety. By contrast, the proposal would reinforce highway safety efforts in several ways. It would permit the accident compensation system to yield undistorted data for use in systematic approaches to highway safety. It would impose special cost burdens on drunken driving and would give commercial vehicle owners an economic incentive to improve driving conditions for, and to promote safe driving by, their employees.

The proposal should also advance traffic safety by enabling insurance premiums to vary as among makes and models of car, according to each car's ability to protect occupants and to resist damage. Insurance premiums could then, for the first time, be used to encourage car makers to make safer cars. That can only be done if the car owner is insuring his own car, rather than insuring some car he will run into and whose make and model obviously cannot be foreseen. It is ironic that when the State's largest auto insurer, a vigorous opponent of reforms such as we propose, recently announced a premium discount for sturdier automobiles, the insurer

proposed the discount only on collision insurance—a first-party, no fault coverage that would be the main insurance for vehicle damage under our proposal.

Traffic safety is mainly the responsibility of other laws and institutions. The proposal would in no way interfere with such other efforts as traffic law and enforcement, strict licensing of drivers, and civil actions against automobile manufacturers and others for bad design, fabrication and maintenance of roads and vehicles. But at least we can have an accident reparations system that helps, and does not hinder, those important other efforts.

Conclusion

To sum up, the Insurance Department concluded after its study that the present automobile liability insurance system is unsound, that it deals badly with both accident victims and insurance consumers, and that it does so for reasons that are fundamental and that call for fundamental change. The Governor's proposal would make such a fundamental change.

In writing the report, we in the Insurance Department were guided by the belief that the Governor, the Legislature and the public were entitled to be told the facts about automobile insurance, and to have presented to them an alternative that would be more in the interest of insurance consumers and accident victims.

As you consider all this, I would respectfully commend to your attention three things.

Number one, the context in which any alternative should be considered is the present fault insurance system. That's what we have today, and some people have an immense interest in seeing to it that the fault insurance system is what we have tomorrow and henceforward. It is not necessary for me to impugn their motives to warn you away from their logic and their tactics. By all means consider their criticisms of our proposal and of all other proposals for really meaningful reform. But don't let them get too quickly off the subject of the present system and its fundamental defects. For the present system is their system. The past, with or without palliation, is their program for the future. Let them defend it.

Number two, please separate carefully what is essential to reform from what is not. Disagreement about levels of benefits for compulsory insurance, about compensating non-economic losses, about whether auto insurance should be primary or secondary to other sources, about whether auto physical damage insurance should be compulsory, about second-level cost transfers, about interstate questions—all are important, but none is of the essence of fundamental reform. You have our recommendation on each point, but you could decide each one differently and still achieve fundamental reform of auto insurance. What is of the essence, what must be

done to secure real improvement, is to do away with the fixing of legal fault as the prerequisite to insurance payment, to do away with vague and open ended measures of the amount of insurance payment, and to do away with a system in which the consumer pays for insurance whose benefits go to everyone but himself.

Third and last, we should all remember that tottering institutions—defensive and fearful, out of touch with their roots, out of touch with reality, out of touch with the needs of the people they profess to serve—such institutions, however formidable and entrenched, eventually fall. The institution known as the fault insurance system was not first criticized by the Insurance Department. The fault insurance system has been exposed again and again as slow, wasteful, unfair and inhumane, living only on myth and momentum and on the dexterity of its operators at confusing the issues and obstructing change. But change will come. Eventually change always comes. Here at least we have all had ample warning and a chance to influence what is bound to happen.

The Future of Federalism in Insurance Regulation

The last people to decide whether a regulatory system should survive are the people who run it, and next-to-last are the people it regulates. Yet the question holds for both of them an enduring fascination, and their capacity to fret and chatter about it has no known limit.

State regulation of insurance is part of the larger culture of regulation. The universal preoccupation with survival is as marked here as elsewhere. The one variant is that in insurance there is thought to be a meaningful alternative—regulation at the national level of government—and so the question of survival comes up in the form of national versus state regulation.

Conventionally, the state regulators have defended their existence by inveighing against the octopus of the Potomac and by declaiming the accepted virtues of government closest to the people. With matching candor and sophistication, spokesmen of the industry have egged and oiled the boasts and jingoisms of their regulators, and meanwhile, back at the office, have calculated with a finer pen what regulatory arrangements would add up to the desired sum of credulity, predictability and support.

Each of us has tended to look at the question in terms of his own goals, not to say his own interest. But neither of us is, or should be, entrusted with the power of decision. If we would foretell what will become of us, perhaps we should practice looking at the matter from the public's point of view. Let us reflect upon whether our system, a private insurance business regulated by the states, is as good a means of attaining the public goals of insurance as are the available alternatives.

It is more a question of mechanics than of goals. It is a question whether the states or the national government, or some combination of the two, can better do, with respect to insurance, what the public has a right to expect a regulatory system to do.

First we should ask if we can recognize a good regulatory system or a good regulatory agency when we see one. It's not a fatuous question.

Too often the makers of public policy find themselves raging at some regulatory agency or other, frustrated that they cannot force the agency to do its work more efficiently, consistently, fairly or flexibly. But they are unable to secure the result they see so clearly, and certainly are unable to make it endure past their first

inattention. Why? Perhaps because they have not taken the vital step to a higher level of abstraction—deciding what they want the agency to be, giving it those qualities which will enable it to run the way they want it to run.

So let us begin by asking what are the distinguishing qualities of a good regulatory agency.

Granted that any public agency must begin with an honorable devotion to the public interest, we might list the main, specific qualities of a good regulatory agency as competence, independence, power and vitality. These four qualities are not exhaustive; they overlap, interact and reinforce each other; they may not even make up the best list of their kind, and it is certainly a current and not a permanent list. But these four qualities do have one very useful thing in common.

They are qualities of the agency itself and not of the agency's work. They are qualities of the agency and, as such, are matters which the public and its government can do something about.

To what extent a regulatory agency will be competent, independent, strong and vital will, obviously, depend on many things. Our question is whether it will depend on the level of government of which the agency is part. There the record is mixed. Let's look at it.

The competence of an agency begins with the abilities of the individuals who come to work in it. In recruiting, rewarding and holding able people, the larger organizations have a head start. In training the newcomer, the older organizations, with the experience and tradition, have a head start in building the competence of their future generations of professionals.

The competence of an organization is more than the sum of the developed competences of individuals. It depends on how well the organization puts their efforts together and on how well it offers them ways, as individuals, to use their abilities to the utmost in work they believe to be worthwhile. How often, in government and elsewhere, this quality—the creative use of able people—seems to elude, or to be ignored by, the very large organizations!

The second of the four qualities is independence. What is independence?

First we think of independence from the regulated industry—meaning not the absence of contact, but an independence of view and a freedom from undue industry influence on agency policy and decisions. Independence in that sense is subtle and, except for outlawing the more theatrical forms of misconduct, impossible to legislate or to order.

The real independence of the regulator from the regulated is not the absence or rejection of something. It is the stronger presence of something else—of a separate sense of purpose, of a concept of the public interest shared by the people in the agency and seen by them as their goal.

The agency's sense of having a value and purpose of its own, not derived from either boosting or harassing the regulated industry, can be developed. But it takes a deliberate effort, one more likely to be successful in a small agency than in a large one, in a new agency than in an old one.

Independence, as a quality of a good regulatory agency, means more than independence from the regulated industry. It means political independence—the ability, and the will to do the regulatory job without favoritism and without pandering.

Different kinds of politics are apt to be involved in different jurisdictions and in different kinds of regulatory activity. Political pressure for favoritism is most likely to be brought to bear in the disposition of individual cases—where the agency is giving or taking away something of value to a particular businessman who is someone else's constituent or patron. Resistance to that kind of political pressure turns on the agency's own political strength and on the morale and character of its personnel. It does not turn on the level of government at which the agency is found.

While any good public agency must be sensitive to the public consequences of its acts and responsive to the desires of the public which it exists to serve, the good regulatory agency also needs a balancing political independence which enables it to resist doing something which is popular but unsound, which merely takes the heat off, or which is desirable in the short run. Good regulation is not a device by which government sacrifices the future to the present or by which it sabotages the consuming public, or the providing industry, by indulging the fads or passions of either.

The third quality of a good regulatory agency is power—the legal authority to do the job which the law and reasonable public expectations set before the agency.

If that principle seems obvious, it is instructive to reflect on how poorly, at all levels of government and in many fields, the principle has been carried out.

Over and over again we have created agencies with what we thought was a clear public mandate, and later we have seen those agencies drift into a bickering senility. Why?

Sometimes the mandate itself was not a directive but a dream, not a setting of priorities but an abdication from choosing among laudatory and mutually conflicting

objectives. Sometimes, of course, the purported mandate was a sham, and when the agency was later exposed for failing the public it was being measured against a mission which its creators never intended for it.

Much of what passes for regulation is really a government mechanism for protecting the industry from itself and from intruders, for retarding change and for stabilizing demand, costs and profits. Insurance regulation, while not without those features, is far from the most striking example of them.

But even where the public mandate is real, the agencies often fail to get results. Are their members merely more timorous and servile than the rest of mankind?

More likely it is that while we give an agency draconian sanctions which, if ever exercised, would be cruel and self-defeating, and while we give an agency the power to admonish and enjoin others to do what they should be doing anyhow, we fail to give the agency sanctions in between.

More likely it is that while we tell the agencies to act forcefully, we hobble them with procedures borrowed unthinkingly from the courts.

While procedural and judicial checks upon administrative regularity and fairness are important, we must not think we get them for nothing. Often the price in agency effectiveness is very high, particularly as those checks are elaborated beyond their original purpose of assuring due process and into an imitative judicialization of regulatory procedure and a judicial repetition, rather than review, of regulatory acts. In any regulated industry with many firms far larger and wealthier than the regulatory agency, the result is to make strong and even-handed application of the public mandate a prolonged, uncertain, wearing and disagreeable exercise.

In the giving of regulatory power commensurate with the regulatory mandate, the record of the states and the national government is uneven and frequently bad. There is not much ground for choosing either one over the other.

The final quality of a good regulatory agency is vitality, the quality of being alive.

Vitality comes with the sense of purpose which keeps an agency truly independent. Vitality of the agency is largely made up of the vitality of its people, of their interest in what they are doing and their sense of its worth. Such vitality comes from seeking talent, rewarding talent, and giving talent the chance to engage, to stretch, and to get excited.

At least in giving good people a chance to develop rapidly and to gain responsibility and prominence as soon as they are ready, a good smaller agency

should be better than a good large agency, and many good smaller agencies would be best of all.

The agency's vitality is also something besides the aggregate vitality of its people. It comes from using the resources of the agency on things that matter, and avoiding the deadening preoccupation with familiar things that matter little or no longer.

The vital agency is constantly looking critically at what it does and at what it does not do. The vital agency is capable of change as circumstances change. It regards self-renewal as a normal and continuing process, as an object of pride and not embarrassment. As circumstances and problems change, the vital agency is alert to take on new functions and equally alert to change present rules and cast off present functions when they no longer serve a public purpose.

This kind of vitality depends on the leadership of the agency. It is the only one of the qualities of a good regulatory agency, or of any good organization, which has to come from the very top.

Of the four attributes of a good regulatory agency—competence, independence, power and vitality—we have seen some which are more likely in a state agency and some which are more likely in a national agency. Which kind of agency is better, on balance, depends on which of the attributes one regards as most important. It is a close question and, since it is close, a rational choice between state and national regulation of insurance would not turn on the relative quality of two typical agencies, one state and one national.

Instead the choice should turn on how well the system of state regulation of insurance, made up of many agencies, compares with what we might expect of a system of insurance regulation made up of one agency that was part of the national government. Before turning to the question of whether such a choice even exists, whether what we call state regulation and national regulation are practical alternatives, let us look at the advantages and disadvantages of the two regulatory systems as systems.

A single regulatory agency in the national government would probably be more efficient and more uniform in its operations, and less susceptible to certain kinds of political pressure. It could close gaps in enforcement traceable to the incompleteness of any one state's control over interstate activities. Duplication of work, at least as among territories, would be reduced.

A single national agency would offer a mechanical convenience, and perhaps a philosophical hospitality, to very large, national enterprises. Geographic favoritism should be reduced. Rules for the conduct and taxation of a major group of financial

intermediaries, and rules for the use of some massive aggregations of capital, might be better integrated with national economic policy.

Finally, if national policy called for the national government to continue to expand its role as a provider of insurance, the national government as insurer would probably find the private insurance industry more cooperative if the national government also had regulatory leverage over it.

Depending on where you sit, some of all of those are formidable advantages. But from the public point of view they are outweighed by the advantages of a state system. There are four.

First and by no means inconsequential, the state system exists. I hope it is not excessively conservative to believe that, even today, it is usually better to improve existing institutions than to throw them out and start over. Even assuming that regulation by the national government would pre-empt or oust the present system, such a shift to exclusive national regulation would pre-empt much that is good along with the bad.

On the regulatory side, it would sweep away much of the accumulated, prescriptive competence to be found in the best state agencies. On the business side, such a shift would put in doubt for years many of the rules within which the business has taken shape and would leave many in the industry with no familiar way of making their views heard as those rules were being redesigned. On the consumer side, the known local points for applying citizen pressure would be dispersed, obscured and removed.

Conversely, the hypothetical national regulatory agency does not exist. If state regulation goes, it will go with a bang or a whimper, after a sudden economic collapse or after years of miscellaneous encroachments. Whether it entered by calamity or stealth, the successor national agency would be of a form and substance quite beyond present control or present foreseeing. That might be a good gamble, but it should be recognized as a gamble and not mistaken for a choice.

Second, as is incessantly pointed out, the states are a level of government closer to the people than the national government. The question behind this slogan is whether the closeness will lead to, or will impede, effective action on the problem at hand.

In insurance regulation, the big problems in the future are almost sure to be concerned with markets—with the availability, extent, form and price of coverage and with the handling of claims. As long as prevention of company insolvency has been the overriding goal of insurance regulation, the problems of multi-state regulation of interstate corporations have been very real.

But recent developments will force us, and will enable us, to put the prevention of company insolvency in a new perspective and to raise the relative importance of other regulatory objectives, especially those concerned with market conduct.

Market problems tend to depend on local conditions, and the parts of the insurance enterprise which most affect market quality are quite decentralized. All the means to regulate market conduct of insurers, and greater incentives to do so vigorously, exist at the state level.

A third reason for preferring state regulation to a single national agency is the pluralism and diversity within the state system.

A pluralistic institution such as state regulation involves agencies of limited size. There is much we do not understand about the regulatory process, but it is clear enough that economies of scale taper off as size increases, while some of the well-known problems of bureaucracy just keep getting proportionately worse.

In a field as imperfectly understood as government regulation of business, we can also favor a number of agencies over one agency. Such a system is conducive to experimentation. Similarly, pending the cure of all human failings, there are real advantages in a system of decentralized and limited jurisdiction, in which evil and incompetence can at least be quarantined.

And because of its pluralism, state regulation as a system should have greater vitality than would a single national agency. The scope for creative top leadership is greater in the smaller organizations, and the likelihood that such leadership will be found at the top of an agency somewhere is, of course, greater in a system with many tops than in a system with only one.

Creative leadership is contagious. Vitality can spread through a state system, for the work of one vigorous agency will be imitated, competed with and used as a standard in other states. The difficulty of keeping our regulatory agencies vital, capable of self-renewal and capable of change to meet changed conditions is perhaps now, and will surely be in the future, a graver public concern than the occasional awkwardness of a multi-state regulatory system.

A pluralistic regulatory system should also be less of a deterrent to creativity within the regulated industry. Unfortunately, any regulatory system tends to retard innovation and suppress diversity in the regulated industry, but a regulatory system that is itself diverse is at least more apt to be receptive and tolerant.

A final and unique advantage of state regulation is that the national alternative always hangs over it. The state agencies are subject to review,

investigation and embarrassment by the Congress and others in the national government. Congress always has the power to abolish us if it finds us incorrigible; we all know it and it concentrates the mind wonderfully.

Without doubt this surveillance makes the state regulators do a better job. With national regulation, however, the watchers would not be so skeptically watched or credibly menaced. For on the record, congressional oversight of the national regulatory agencies has been no better than state legislative oversight of the state regulatory agencies, which means it has yielded fewer benefits and more bad side-effects than has congressional oversight of the state regulators of insurance.

With this hint that what we call state regulation is really a mixed national-state system, we may ask about its future. What can we expect as the future of federalism, that is, of national-state relations, in the regulation of insurance?

The two levels of government will continue to press upon each other, and both will press upon the insurance business. Even apart from the merits, neither past history nor present politics gives any substance to the hope or fear that the national government will pre-empt or exclude the power of the states to regulate insurance or will bestow upon firms in the industry the delight of choosing by whom they will be exclusively regulated. Reinforcement is likely, duplication is possible, but the use of national power to insulate the insurance business from the efforts of the states to protect their citizens is out of the question.

Instead, the question is what relations between national and state government, and between each of them and the insurance business, are likely and desirable.

The relations between the national government and the insurance business are apt to be of a different kind than the relations between the states and the insurance business.

The states will continue primarily as regulators, as the term is now understood. But regulation is not the only way of exerting public control over decisions and operations relating to the distribution of economic risk and the protection against financial loss.

Ownership, operation, conditional subsidy, comprehensive planning and contract for services can give at least as much control as can regulation, and are the more customary approaches of the national government in those areas where it impinges upon the insurance business.

Thus the present national debates over what we now call health insurance and crime insurance, and other foreseeable national debates over protection from

economic loss, are far less debates over regulation than debates over program. They are far less debates over insurance than debates over economic and social problems in which insurance is seen, and dealt with, as only a part of the problem or an implement for its solution. Once the program decisions are made, the national government's relationship with the insurance business is most likely to be that of planner, partner, employer, supplier, customer, competitor or successor.

As between the levels of government, it is safe to predict there will be relations in the future. The national government shows no signs of withering away or of losing interest in the state regulators of insurance. The nature of the relations will be, in a sense, regulatory—consisting of continuous surveillance and selective direction.

Today the signs are that the state regulators are coming to recognize the legitimacy and value of, if not precisely to enjoy, surveillance and sound criticism from the national government. In the past the states have sometimes reacted to criticism from Washington with a reflexive denial that anything was wrong and that the national government had any right to speak about insurance. At the other extreme, the states have sometimes reacted to a casual, undocumented or irresponsible criticism from Washington by doing, with equal irresponsibility, what the criticism called for, just to make the critic go away.

Beyond surveillance and criticism, the national government can be expected to reinforce state regulation by the selective use of national legislative power—by identifying areas where the inherent limitations on state jurisdiction over interstate business or a demonstrated lack of will or ability by the states to deal with an obnoxious business practice may make it better for everyone for the national government to fill jurisdictional gaps, to set standards or to command the states to act.

We can look for the states to acknowledge more than they have in the past that areas exit where national government help is necessary, and that it is often better to get rid of a problem than to maintain a pure ideological position. We can look for the states rightly to insist that, in considering particular interventions, the national government consider as well their effect on the overall regulatory system. We can also look for the states to try to head off such interventions by taking on the tough problems first, by improving interstate cooperation and by closing the gaps and reducing the overlaps and parochialisms in the multi-state system.

In both aspects of national-state relations, there are some reasons to expect, and many reasons to hope for, more professional and responsible conduct on both sides.

State xenophobia toward the nation is going out of style among the regulators of insurance. And responsible national officials are neither so vain nor so oblivious of the national regulatory record as to believe that the national government has all the answers to the problems of insurance regulation.

Just as, in the interest of a vigorous mixed economy, we can welcome government involvement in insurance problems, so also, in the interest of effective regulation, we can welcome national government pressure upon, and assistance to, the states. We can welcome a thinking national presence in the interest of durable state regulation, surviving for the right reasons, surviving because of its strengths and not its weaknesses.

In the American experience, federalism brings tension, friction, overlap and competition between the levels of government. But when it is working well, federalism also brings flexibility, an ability to change and a combination of the strengths of national and state government. We can hope for the pattern in the future of federalism in insurance regulation.

Whatever its lack of symmetry, our mixed regulatory system works and, unlike other regulatory systems, shows signs of improving with age. It is almost certainly better and more vital than anything we would have planned in the past or would be able to plan now. It makes room for logic and experience and change and diversity and renewal. In many fields and at many times, that has been the genius of American federalism, and, in insurance and insurance regulation, we can hope it is the future of federalism as well.

Rationality and the Promise of Insurance

In retrospect, the bygone fire insurance business appears serene. Protected by combination, mystery, uniqueness and regulation, their size and wealth exalted as public goals, the mountainous insurance corporations were surely permanent and unchanging. Yet, in retrospect, the bygone fire insurance company seems incomplete and passive, controlling not its sales or its prices or its costs.

Holocausts of fire and politics swept the bygone fire insurance industry, but left it more uniform and secure. The fires raised to public goals the pricing cartels and other engines of collective entrenchment. The political alarms brought government to regulate and reinforce the private arrangements; to serve in its maturity as keeper of the known, scold of change and familiar for the magical transfer of responsibility from management; and, in law and contract, patiently to weave between the business and the citizen a bafflement out of a filigree of exactitudes.

In short, those holocausts made the insurance business as a whole more secure and the individual company less its own master.

The next events did just the opposite. They made the industry less secure and each company more active, vigorous and self-reliant. Beginning less than thirty years ago, new lines of insurance, with new traditions, became dominant. Companies acquired new powers and came under new laws. The industry was invaded by merchants, newcomers who regarded personal insurance as merchandise to be sold hard and competitively and to be made at the lowest cost.

The great old companies accepted the merchant idea and began to compete at the consumer level. The individual company began to take control of its pricing, its product design, its marketing and its costs. For management, the area of responsibility grew, and encroached upon the area of fate.

Government saw what happened in the insurance economy, and came to encourage competition, diversity and change. Finding reality vivid enough, the insurance regulators became less susceptible to the narcotic pleasures of the quieter regulatory life. Like the leaders of the business, they grew more alert, more questioning and more self-reliant.

Annual Meeting of the American Insurance Association *New York, NY* *May 18, 1971*

Having adjusted to the new merchant tradition, the property insurance business and its regulators are certainly entitled to rejoice in their new strengths and to do so in repose. But there is not time. A new force is upon us.

Everywhere in the economy, demands are being made on great economic institutions to do things, in the public interest, which the institutions have traditionally believed to be outside their responsibility. Power is being ascribed to the institutions which they traditionally believed they did not possess or should not exercise. The institutions are being called upon to consider the social consequences of decisions heretofore considered purely economic and to consider as decisions acts heretofore believed to be mere market reflexes or automatic responses to technical advance.

But in the long run, unless they are just a fad, the new demands will be quite effective, for great institutions are especially vulnerable, and responsive, to ridicule backed by research. And in the long run the regulated industries are apt to feel the new demands most acutely. Those industries are long and widely regarded as affected with the public interest, and they are already in the grip of exposed and apprehensive government agencies which are themselves responding to similar demands.

In insurance, the business may be held accountable both for its own quality as an institution and for the quality of everything it can help to shape. Insurers and their regulators may come to be held responsible, not just for fairness in each product or insurance transaction, but also for the total fairness of insurance as a mechanism for allocating wealth and costs. Insurers and their regulators may be held responsible for the desirability of the various conditions and kinds of conduct which insurance subsidizes or penalizes.

To meet such expanded responsibility, the newly invigorated insurance business and insurance regulators can be expected to make the various insured events, just as they have made the business itself, more rational and controlled.

The insured event is rational to the extent that what the policy covers conforms to reality in a logical and intelligible way. Rationality is hardly new to insurance. Most insurances began with rational insured events but, in many, reality slipped away with the years. The return to rationality is not easy. The irrational requires high professionalism and expense to make it work at all, and interests vest in its preservation.

Making the insured event rational calls for continuous critical examination of how well what is insured conforms to what is happening and what is needed. It calls for a continuous weeding out of obsolete proofs and distinctions. Today's examples

are no-fault automobile insurance and broader insured perils in property insurance, and there will be others tomorrow.

The work is never complete, but it is worthwhile. Where the insured event is rational, the insurance mechanism can be more efficient and stable and predictable in its operation. Government and insurer managements can rightly concern themselves with the insurance mechanism as a system, rather than with cajolery and coercion in individual cases.

Insurers may also be called upon to help control the insured event. Insurance is uniquely able to put a price on different kinds of conduct and to make future, indirect and uncertain costs visible in advance. The insurance mechanism can translate qualitative and escapable realities into a form which consumers and businessmen can measure and believe in.

Controlling the insured event is not a new responsibility for insurers. But more than in the recent past, insurers are recognizing the importance of putting a fair and visible price on differences in hazard, of refusing to spread costs irresponsibly created, and of considering the social consequences of spreading costs in different ways.

As with rationalizing the insured event, the pressure on insurers to control it will continue. The work is never over. It did not end with iron hulled ships; it will not end with bumpers on cars.

Rationalizing and controlling the insured event are interdependent and complementary, however tempting it sometimes is to concentrate on one to divert attention from the other. They will progress together, and, in particular, real control over the insured event will depend upon rationalizing it.

The new demands will be difficult to meet. They go to the core of your business, quite beyond what can be satisfied by rhetoric, charity or easy consensus. The strain on individual companies will be great. The property insurance business no longer has the cartel to shield the generous, as it shielded the inefficient, from competitive disadvantage. Instead, in remembrance of that past, the business has an unconcentrated market and the individual company still has only imperfect control over its own prices, sales and costs.

Yet you have special resources, in the business and in government. The fall of the cartel, the rise of the merchants, and the new will to comprehend and control more of the insurance enterprise have given insurer managements the strength to welcome change. Government as regulator can help make coherent a cacophony of external demands and can remove the market disincentives to responsible conduct by the single firm, and you will need both kinds of help to stay private, profitable,

responsible and sane in the days ahead. Even the peculiarities of state regulation—its unevenness; its informality; its accessibility to the providing insurers, the consuming public and the rest of government; its immersion in the local setting of the insured event—which are hardly strengths under all circumstances, may be strengths in the period of transition and experiment which lies before you.

One comes to know change by its symptoms or else by its scars. Knowing early, you can move beyond the modest responsibility which a wise society assigned the insurance corporation in the days of its incompleteness. You can help rationalize and control the insured event and can help others know the true costs of their conduct. If you do, you many reconcile social responsibility, short-run profit and long-run profit so exquisitely as to be the marvel of your corporate brethren. And you will have said best, at a listening and skeptical time, that great private power can as will be great in service.

Regulation in Retrospect

On any occasion like this more than two years ago, I would probably have conserved the audience's time by stating right off that regulatory systems tend to become closed and inbred, overly restrictive and inherently out-of-date. My comments would have been direct in condemnation of government and would only have hinted with the nicest delicacy that regulated business brought most of its troubles on itself.

An evaluation of the present system thus quickly out of the way, I would perhaps have launched into one or another program to clean things up, a program which had to look relatively attractive to an audience which had just looked down at the muck of its present situation.

Today, having neither a program nor a regulatory office to render seemly much candor about regulation, and fearing to offend the countless government officials who aspire to regulate, restrict, restructure, employ, replace or merely swear at insurers and banks, I shall be more circumspect. Today, instead, trusting in our tacit, shared understanding of the nature of the regulatory predicament, I should like to talk about how, in all likelihood, we got there, about why so many regulatory problems seem intractable, and about how, given an honest appreciation of how deep the problems are, we ought to approach their solution.

Historically in this country, regulatory agencies are created when private business power is seen to have gotten out of hand—when monopolists and cartel managers are holding the citizen to ransom; when jungle business, in a blood-frenzy of what is called competition, seems bent upon cannibalizing itself; when a market seems to invite cheats and overreachers to set upon victims besides one another.

When government, with substantial public support, becomes convinced that something of this sort is going on, government is apt to create some agency to stop it. At the time, the public will commonly remember or imagine an earlier day before things went wrong. So the new agency, while born of fury against specific private abuse, is apt also to be mindful of the value of private enterprise. Its mission will seem clear and simple, but will often be accompanied by a becoming respect for complexity. Fighting may be fierce, but the opposing lines will be rather clear and the field of combat will not be total.

Soon, however, the fighting dies down and, though it seems contradictory, the field of combat—or, rather, of involvement—spreads wider and wider. The former combatants are not so much fraternizing personally as they are occupying each other's territory.

First National City Bank Insurance Forum *New York, NY* *November 2, 1972*

Considered purely as a political or governmental entity, the mature regulatory agency at this moment may look like an appendage of the regulated business, showing its political heritage mainly by its obsession with jurisdictional balkanisms and by an occasional binge of press agentry, but otherwise serving as protector of what is dull and inefficient in the business, as confessor of industry's peccadillos and resolver of its spats. When the public sees this sort of carrying on, it feels sold out—for the last time it looked there was a good fight going on instead of all this familial bickering—and the public and its leaders and vigilantes set out for vengeance upon those who presumably bought and sold the public trust.

But the mistake was not so much one of misplaced faith as of limited vision—on the part of all of us, as citizens, observers, businessmen and government people. We think we set up purely government agencies to deal with purely business problems, but for the long haul what we really do is found regulatory systems—complex and living—which we have to think of as systems if we would understand and predict, let alone influence, their behavior.

What begins as a simple contest of the people against the pirates or the producers against the bureaucrats, depending on your point of view, changes over the years in response to one very basic human need—the need to reduce uncertainty. It is the same need which makes us willing to pay in freedom and money to reduce risk and to stabilize our surroundings in other ways, whether it be through feudalism or etiquette or monopoly or, in extremis, even commitment fees and insurance premiums.

The human desire to reduce uncertainty works upon regulator and regulated from the start. Winner-take-all contests, definitively disposed of in close fact situations, are seen as the ultimate in uncertainty, and so both government and business move instinctively toward consultation, compromise, consent and confidentiality—toward a system where everything is cleared in advance, where there are no surprises, where no one dares and no one really gets hurt or is ever left with no one else to blame. In the witchery of business survival, government becomes a familiar for the magical transfer of responsibility from management.

For government, the need to reduce uncertainty tends toward the increase of power. It leads to a constantly expanding regulatory jurisdiction, to tame the unpredictable barbarians just over the next border. It also leads to a bureaucratic interpenetration so thorough and an aggregate regulatory leverage so great that government—given sufficient awareness of its own power, willingness to use that power for collateral purposes and promised length of memory—can get almost any subject business to do almost anything at least for a while merely by asking. In time, regulated industry thus becomes perhaps the most favorable of all terrains upon which to employ the weapon first used by Samson upon the Philistines.

Finally, the need to reduce uncertainty works upon regulator and regulated to atrophy their ability to deal with each other on fundamentals. The men of business and of government see each other as reflected in the increasingly aimless, manipulative and trivialized regulatory relationship, and they tend to lose understanding and respect for each other, not personally but in the sense of appreciating the other's values and his vocation. Fully occupied by the subtleties of his own immediate culture, each reduces the uncertainty of his total world by drastically simplifying the rest of it. Oversimplifying the outside world helps one feel superior to it and competent to deal with it, and oversimplifying one's view of another institution based on what one sees through the regulatory relationship can produce delightful caricatures. But it can also lead, in times of stress, to reciprocal bafflement and frustration, and to the impossibility of holding the meaning of basic words still long enough to learn what the other fellow is really after and to explore together whether fundamental objectives can be reconciled. Regulated business, almost by definition, pre-empts the attention of the agencies, and government regulation does, as a practical matter, occupy much of the mind of regulated businessmen but, as in other areas where quantity and quality can get confused, preoccupation with a subject is not the same as understanding it.

All of this is to say that as regulatory systems mature they expand and entrench themselves in both business and government and that they tend to assimilate business and government to each other mechanically but to estrange them intellectually. Each party may be comfortable but gradually he may also be debilitated, becoming less able to function alone or to think clearly about the relationship. At some point, the regulatory system becomes indeed a single, integrated system.

From then on, the regulatory system responds to specific and limited changes in complex and resonant ways. Change does not then become impossible, but change which is intelligent and enduring seems so often to elude us. The reason is that touching one part of such a mature regulatory system affects other parts, so that our efforts at reform often produce side effects and unintended results of greater magnitude, and sometimes overbalancing wickedness, than the good we set out to achieve. Similarly, the other parts of such a system act upon the one we seek to change, and their sure tendency is to reject what is new and to restore the old equilibrium.

Lasting change in a mature regulatory system must, then, either be total or at least be based on a total understanding of how the system works and of the effects throughout it of a shift in any part. That is why lasting change in regulatory systems so often comes about through scandal and public outrage, through external audit and, most often, through the collapse of the regulated business or the entire regulatory apparatus. For only then is it thought of as a whole. Short of that—and usually the public, government and business are well served to stop short of that—

lasting change must nonetheless be based on equally comprehensive thinking about the regulatory system. For in the maturity of the regulatory worlds in which we live, we have to engineer change and can no longer simply command it. What we would now change partly we must now first fully understand, and only the radical mind can guide the hand in moderation.

The Quiet Dying of the Great Cartel

Insurance, as a concept, brings together steady capital and occasional need, so as to make adventure prudent and serenity possible.

Insurance, as a practice, offers the exhilaration of making clear decisions, backing one's professional competence with nerve and money.

Yet the property and casualty insurance business does not exactly and always behave according to the beauty of its concept or the pleasure of its daily activities. Why?

Perhaps the answer is in the history of the business and in how it is changing through time. In that history there is one singular fact. It is that we have inherited the remnants of one of the few cartels in this country, in which, by agreement among competitors, prices were fixed, costs were fixed and products were standardized.

Once upon a time, property and casualty insurance meant fire insurance in the cities of the industrial revolution, with only the crudest of construction standards, fire protection or loss data. The business consisted of a few young, tiny, and surely timorous financial institutions, faced with appalling exposures in a marketplace in which the common method of starting out was to give policies away. On that frontier, agreeing on rates was a responsible act of corporate survival, shunned only by plungers.

Later, as other parts of the competitive environment were seen to need stabilizing, insurance executives turned again and again to the technique of agreement. In time, the agreements and the machinery for their enforcement grew into powerful engines of conformity—the bureaus and boards and fire insurance exchanges, the eastern and western unions, the adherence compacts, in-and-out agreements and acquisition cost conferences—all private law policed by private governments caught up in the romance of self-regulation.

It all made for a dependable and rather clubby business environment. Shielded from the anxieties of competition in price or coverage, businessmen could consecrate their energies to non-price competition, nearly all of which is harmless to the competing businesses and much of which is rather pleasant. For as long as the fences hold and the consumer stands in his stall, cartel living is good. There is plenty to go around. Underwriting is jovial and a company's only concern with agents is their seduction.

CPCU Conferment Luncheon *New York, NY* *October 25, 1973*

By any internal standard the fire insurance cartel was honorable, even righteous. It was intermittently lawful. But it was not exactly in the mainstream of American legal and economic thought. From the inside it looked stable, even majestic. But it was a stability of delicate balance.

Gradually the fire insurance cartel was weakened by non-conformists and intruders and by the shift of public apprehension from fire to automobile, and, finally, its hold was broken by law.

But the ending of so ancient and pervasive an institution as the fire insurance cartel is not an event; it is a process. While today the old agreements are gone; while today insurers compete fiercely in price and coverage; and while today the cartel is dead as an institution; nevertheless we today must daily reckon with its memory.

The cartel once dominated what was the main part of the insurance business, was echoed in other parts, and was strongest during the business' formative years. Its dissolving exerts a powerful force on insurance today. Its shadow reaches through the structure of our business. Much of the language of words and numbers by which we understand our business is the cartel's legacy. It is the inescapable background of the way we measure size, cost and profit; of the way we compute rates and classify risks; of the way we conceive of our products, services and markets; of the strengths and weaknesses of companies and producers and their relations with each other; and of how government regulates rates, markets and solvency.

For years to come, we will feel the effects of the cartel and of its fall, but we can be glad for the gentleness of the debacle. We bought time with law and myth and habit, which now look quaint or nostalgic or reactionary, but which did hold change to a pace we could endure. We have had decades to prepare for a present and future in which professional skill, good management and clear thinking will be more needed, and probably better rewarded, than in the stable, clubby, old days. Henceforth the insurance business will be better able to make adventure prudent and serenity possible, and we will have the chance to do its work and prosper, thanks largely to the manner of the dying of the great cartel.

The Relationship of Insurance

We insurance people too often regard the claim as an inconvenience, a misfortune or the penalty for a bad bet. We may be fair about claims, but we are seldom gleeful.

Claims arise under agreements written to protect us insurers from all that is not foreseeable and much that is foreseen. Sometimes, usually in commercial coverages, the policy is designed to express a bargain precisely, to build good fences between good neighbors. Sometimes, usually in personal coverages, the policy expresses no concurrent thought at all.

In the basic personal insurances it has become fashionable to look upon what we sell as a product. It is an instructive metaphor for marketing, and, in a larger sense, products may indeed be what our personal insurance policies have become—products standing on their own, bearing no understood connection with the insurance relationship which should underlie them.

Who among us understands the entire homeowners or automobile policy? Who among us would assert that the written words dictate how claims are really paid? Who among our customers has read, let alone comprehended, those documents in their entirety?

What free people do not understand, or know why to desire, someday they will not buy. Yet we purvey an opaque ball of words to people herded to us by legislatures and lenders and fancy ourselves as marketing a product to free and demanding buyers. Should we expect anything better than the estrangement of customers and the embrace of regulators and humorists?

What mischief of history has drawn such decent folk as we into this predicament?

To begin, we carried over into personal insurance an emphasis on perils and activities rather than on economic losses. Thus we started out with problems of definition and measurement.

Through the years these inherent problems of definition and measurement came alive in borderline cases. Each predatory claim and each populist judgment in a single hamlet had a way of inspiring misanthropic insurance draftsmen across the land. The cases thus left an alluvium of elaboration, exclusion and limitation upon the original insurance document. We insurance people held the pen which wrote the

policies and, through the years, we complicated them to serve our notions of fairness or to confine our mistakes.

Over time we solved the problems of underwriting, rating and claims administration which followed from the original problems of definition and measurement by, in effect, interposing them between the customer and the company. We solved one practical problem after another either by pushing the risk onto our customers through exclusions or by resolving doubt through clarifications of great intricacy. Both of those ways out of our immediate problems were at the long term cost of impairing confidence in the insurance relationship by the most direct of all methods—impairing the relationship itself.

As professionals who called forth these mysteries and are considered most able to give them daily meaning, we naturally cherish them. But in a longer view, we appear to have become entrapped in the labyrinth of our own ingenuity.

What is the way out? It is fashionable today to call for policies to be written in simple, understandable English. This is fine, but it is too unambitious an undertaking to succeed. For complex concepts often cannot be expressed in language which is at once simple, clear and brief. Clarity of expression has a way of following clarity of thought, and successful policy form simplification depends on simplification of the concepts—that is, of the insurance relationship—which the language is called upon to convey.

We may market personal insurance as a product, but perhaps the beginning of our escape from the labyrinth is to see that we should not design it as a product. It is a relationship, and works best when it is a continuing relationship in which funds flow back and forth, in which the individual pays a fee, not for a charm against perils of nature or man, but to be relieved of economic anxiety and to be cushioned against economic reversals which were beyond his bargain with life.

To the individual, the recovery and the even more delicate confidence in contemplation of the claim are the real value in the insurance relationship—more important than percipient underwriting, exquisite rating, flawless processing or any other component of what we call service. They are even more important than lyric policy writing as an independent art form.

Yet if we start with what the consumer needs and then express simply what meets those needs, the other benefits, to us as well as to him, will surely follow. And we can best begin with a recognition that the claim is neither a nuisance nor the end of the insurance relationship, but rather its essence and its beginning.

The Failure of Collapse in Insurance

Six years ago, it was a dull conglomerate indeed which did not lust after the flagrant excess capital of some insurance company. In flight, insurers turned to statutes, regulations, safe harbors and other expedients—all understandable and often effective, but improvisations all. Only this year has the property and casualty insurance business disposed, in a more fundamental way, of the embarrassment and temptation of possessing too much money.

Now insurance people excite each other about the future of a business caught between underwriting loss and a thinned cushion of capital against which to absorb it. Informed, pessimistic opinion has it that the business will collapse or at least so constrict its acceptance of risk as to cripple itself and to exhaust society's welcome. Informed opinion has it, optimistically, that rates will so soar, losses so fall and assets so levitate upon the market or be so pencilled up by regulators that the whole problem will simply go away.

Either of these views may be correct. But history and our scars teach us that conditions and prospects are rarely so good or so bad as they seem. More likely, what will happen to the insurance business now will be nothing momentous at all, but only an alteration of attitudes well worth altering and a temporary slowing of structural changes already under way.

To test the notion, let us look first at the nature of the property and casualty insurance business and then at the structure and attitudes under pressure now.

While a vital part of the general economy, insurance is inherently different from a general business venture in simple and fundamental ways.

The usual venturer knows his costs before he sets his price and sells his product at one price to anyone who will pay. This has not always been true of the manufacture and sale of tangible goods, but at least it has always been inherently possible and has now become true generally. But in property and casualty insurance, conducted as a competitive private enterprise, it is inherently impossible.

We insurers sell today indemnity against tomorrow's losses. Hence we are pricing uncertain future occurrences, which often depend on qualities of our customer, as well as the uncertain future cost of goods and services. We do not know our costs until after, often long after, we set our price. We cannot sell to everyone at the same price.

"I" Day *Columbus, OH* *February 6, 1975*

The simple fact that insurance prices are set before costs is behind the ancient anti-competitive arrangements in property and casualty insurance. Those arrangements, in turn, are behind the most striking feature of the present structure of the business—the amazing number of companies.

The same simple fact of pricing before knowing costs is also behind most of our great travails of the last century—the enforcement, evasion and eventual breakdown of cartel pricing, the tenacity of independent middlemen, the vulnerability of established insurers to competitors with lower known costs, the recurrence of residual markets and capacity droughts, the gyrations of competition and underwriting results and the abundance of short-term incentives to bad management.

Today's particular problems of underwriting and capital follow once again from the peculiar nature of insurance pricing, which prevented us from correcting an earlier misjudgment of the rate of future inflation, as well as from a general confusion between the freedom to compete and the ability to compete. The troubles also follow from a disposition of assets which, in crystal retrospect, seems to have ignored that the purpose of the assets was to cushion against mistake or misfortune in an inherently most uncertain business.

Although we cannot clasp the future surely, still we know the recent underwriting and surplus losses are partly cyclical and partly the result of rare economic circumstance, and both facts suggest they should soon improve. The point here is that, whether or not they improve, today's problems of underwriting and investment do not go to the fundamentals of the property and casualty insurance business. Nothing much has changed except our voice.

Take last year's underwriting losses. No one company can survive really suicidal underwriting. No one company with merely bad underwriting can survive heavy under-reserving, because of its pernicious effect on pricing and its shock effect eventually on the balance sheet. Yet, in terms of survival, the insurance business as a whole can absorb underwriting losses for a long time. If insurers underwent a long series of underwriting losses, they might not be a good investment and might not have much capacity to take risk, in the psychological rather than financial sense. They might not be much fun to work for. But as a whole, the insurance business surely would survive.

What about last year's contraction of capital, of the cushion against error in the inherently, uniquely uncertain business of insurance underwriting? That cushion might, of course, shortly be restored by benign financial markets or by a cheerful infusion of new money. But if not, then either insurers will do their business with a thinner margin for error or they will do their business no longer.

Considering the nature of the property and casualty insurance business and of its problems in the past century, we can pretty safely guess that the business will accept the thinner cushion against error and thence proceed to do its business. It is in the nature of insurers to insure. It is in the nature of the public and its representatives to demand performance from those who willingly have held out possibilities.

Accepting a thinner margin for error in underwriting will, however, affect the structure and conduct of the insurance business.

Underwriting profit will again become more crucial, not so much for survival as for safe growth. Logically, underwriting stability and predictability would be enough even without underwriting profit. But, once again due to the simple fact that prices precede costs, underwriting stability and predictability are even more elusive than underwriting profit.

The demand for insurance seems to be growing faster than the country's investment capital—indeed the relationship should roughly be inverse—and we insurers are somewhat less than infallible investors. Hence, tomorrow's race will be to the craftsmen of insurance, for only they will be able prudently to lever their capital fast enough. Only those with underwriting profits will have the financial stamina or the daring to grow at a pace equal to demand.

The conventional tests of the solidity of insurance companies, basically ratios of premiums to capital, are measures of both the depth of the investment income cushion and of the depth of the capital cushion should all else fail. What they leave out is the importance of the quality of underwriting, for it is clear how little capital would be needed to support an infinite book of assuredly profitable business. For a company which underwrites consistently and well, the conventional tests and ratios are probably too conservative—both for insurer management and for society guiding this vital use of finance capital.

In the future, insurers deserving of your respect and of the people's trust and money will have asked what is their mission and how capital can serve it. Is an insurance company a levered investment trust or is it a risk taker with a cushion? Either alternative may be good business and may be sound social policy, but surely we have learned enough of the arrogance and eventual futility of trying to manage in between. No one knows how to trade underwriting profit, investment income and overall uncertainty, although many who cannot fill your pocket will confidently fill your ear.

We insurers are the bearers of uncertainty in life and in finance. As such we have always needed cushions against miscalculation or misfortune, and we have always found them—in cartel pricing, in the hire of capital through reinsurance, in

bond amortization, in mergers within our culture, in reactionary accounting and, most recently, in a rising stock market.

Today there seems to be, outside the realm of pure faith, only one possible new cushion—an accelerating consolidation of risk-bearing entities, that is to say fewer and bigger companies, so that the law of large numbers can work better upon both underwriting and investments. It is indeed a long-term structural change of the greatest significance. It has been going on for some time although barred from polite conversation.

The change is traceable to the break-up, under pressure of law and economics, of the old anti-competitive arrangements which were made to deal with the problem of setting prices before knowing costs. The end of those arrangements loosed the strongest competitors upon the others, and capital strength is certainly a part of competitive strength.

Will the recent surplus decline simply hasten the process of concentration? On the contrary, it is more likely to retard the process, for many of the hugest and lately most ferocious competitors have been worst hurt by the stock market. As those companies curb their appetites for other people's business and attend more to their own underwriting, the otherwise marginal companies will have a moment's respite, and the well-managed, careful, specialized smaller companies never had much to fear from competition anyway.

The secular trend is still toward concentration, through merger and bankruptcy, but the paradoxical immediate effect of the vertiginous drop in surpluses should be fewer departures and not more.

Over a century the insurance business has thrived despite the strains in its nature and in the vicissitudes of finance. It has thrived despite the melancholy of its literature. It has thrived not always because of the brilliance of its leadership and regulation. It has thrived because it performs functions of real and abiding public importance—the transfer of risk, the spread of loss, the pricing of behavior, the protection of capital and the interposition of financial strength between the individual and threats he cannot bear.

Our business is the purchase of danger for a price, the appraisal of the future. As we appraise our own future now, we should see in the current panic no cause for panic. We should see leverage, depending on the skill of the hand on the lever, as a synonym for the efficient use of capital. We should see adjustment to be necessary and, fortunately, rather obvious. We should most clearly see before us now time to adjust and thereafter time to prosper.

Service and Capital in Insurance

More recently than we care to remember, property and casualty insurance companies—going nowhere in the go-go years, frustrated and seen as unprofitable in their basic business—ventured into unfamiliar fields. Only the most endearing modesty could have led corporate executives so to assess their craftsmanship as to conclude that they could do no worse in endeavors they manifestly knew nothing about.

Thereafter in those new endeavors most of us did so badly that, except where pride, size or irresistible impulse have wed us to our follies, we have gotten out.

Chances are we will not make that mistake again. Only rather dreary folk repeat mistakes. The more spirited seem never to run out of new mistakes to make for the first time.

The new mistake we are flirting with today probably cannot be the monetary or organizational calamity that diversification was, but it will likely share with diversification the ironic failure to maximize the profits of an essentially property-casualty insurance organization precisely in the name of maximizing profit.

The impending mistake will also share with the diversification fad a failure to ask what a property and casualty insurance company is, what it does and how it makes its money. Finally, it will owe a special charm to the 1974 underwriting and surplus traumas, which left insurance companies cautious and feeling poor.

Let us look at what a property and casualty insurance company is and does. In economic terms it is a capital-intensive service institution. It performs many services. The main one is to transfer money following the occurrence of uncertain events identified in advance. It uses its capital to back up its skill in accepting from others the economic consequences of uncertainty.

An insurer performs an essential function when it uses both its wealth and its dexterity to accept and spread risk—to rush money toward sudden need and to give expert counsel in the reduction of risk and the management of uncertainty. Such an insurer has only to do its work well and it will justly prosper. If, in addition, the insurer is inventive and daring enough to distinguish what it does with capital and craftsmanship from what its competitors do, it may find happy customers making it very rich indeed.

Keeping service and capital joined, particularly if the outcome can be differentiated from the offerings of others, is the way for insurers most to profit while

keeping best faith with their nature. Companies can, of course, make some money from either skill or capital alone, but they can only optimize the return on either by using the two as one.

That is not as easy as it sounds. The insurance business abounds in short-term incentives to bad management, and they certainly abound here. An institution with both capital and skill is constantly offered or is constantly observing chances to use the one without the other.

Consider capital. The lure of using capital alone was strongest in the uncritical sixties, when insurers celebrated as creativity their financial transfusions to industries perennially short of it. That was the synergy of the vampire.

Today, more honorably and subtly, insurer capital is being sought alone in such undertakings as payroll deduction plans administered by the broker or the employer, and in high, deep excess covers engineered by the eventual beneficiary.

If the stock market restores our patrimony, we will surely be tempted again to commit it where someone else will do the work. That is all it would take for us once again to feel overcapitalized and understaffed. Whomever we then hired to think for us would fairly demand his special share. Whenever we surrender the ability to combine capital and an essential service skill in a single, indivisible relationship, we may expect thereafter to bargain with every stranger's valuation of the remnant.

Consider service—underwriting, policy design, premium collection, safety engineering, loss payment. Feeling poor after our ten-year round trip in the stock market and ten-year growth in exposures, we naturally want to avoid staking capital.

We possess, and are possessed by, gourmand service organizations built upon past growth, whose nourishment is in jeopardy as capital pulls away. Naturally we look for ways to use those service organizations without committing capital—to manage a captive or mutual where once we insured, to do transaction or data processing for competitors, or to sell for a fee any number of other insurance-related services—all on the incorrect assumption that there are significant economies of scale in insurance which give us, as it were for nothing, excess processing and service capacity.

This could be viewed as just another case of unbundling, a case involving capital and service rather than, say, computer hardware and software. It is that but it is more. For property and casualty insurance as an industry, it is a question of jeopardizing our identity and the unique role in the society and the economy which best justifies our existence and brightens our future.

For the individual company, it is a question of maximizing profit and quality in the long run. In any company, financial capital and human skill will never be in perfect balance. At any one moment, the company will have more or one than of the other.

On rare occasions, it may be wise for the company to split capital and skill and sell or rent to outsiders whichever is in oversupply. But far more often, the company will do better to reorganize its use of the two resources together to achieve a better balance, or to use the excess capacity to introduce new and differentiated products, or to improve service, or to explore fresh markets—in other words to regard the imbalance of resources as an opportunity to seek and exploit competitive advantage in our basic business.

The two institutions, banks and insurance companies, which are most clearly both capital and service intensive, have been invited again and again to separate the two ingredients of what they sell. When in the past they yielded, they generally got what they deserved. Often they did not even know they were making a mistake, because it is quite possible for them to make money while falling far short of optimizing their return on capital, manpower, risk or heartache.

But the big temptations to use skill without capital or capital without skill—tempting to banks because of recent success and the felt need to grow, tempting to insurers because of recent failure and the felt need to contract—are still ahead.

Now to relieve managerial strain and to attain a mirage of free profit, we are both being tempted to design away our distinctive character. Far better that we preserve the integrity of our rare and valuable, indeed our identifying, combination—the command of great wealth and the artistry to place it at the service of others, though never under another's hand.

The Cost of Profit in Insurance

Of late some of the best minds in property and liability insurance – in the business, its regulation and its scholarship -- have been bent to the precise measurement of the profitability of the enterprise, by state and by line. Why and why now and with what likely results?

The immediate reasons are simple and entirely human. Managements are perplexed about profit and capital adequacy. Regulators are eager for tools which appear crucial and scientific. Scholars like to measure things.

More significant are the deeper reasons and the steps to where we are today. Today's preoccupation, or trouble, with insurance profit started long ago with today's subject, or victim, himself—in two ways.

First, when the property and casualty insurance business, meaning fire insurance, was cartelized and most stably and comfortably priced, it was a breach of etiquette to link underwriting profit (income minus outgo as though simultaneous) with investment income (the benefit from their not being simultaneous).

This etiquette, however convenient, did not stand analysis. As early as 1911, the New York Legislature said:

> In trying to discover the sources of the hostility on the part of the public towards fire insurance companies, it becomes of great importance to examine the question of earnings. It has been claimed by insurance companies that the earnings have been small, for instance, that the 'underwriting profit' has been nothing during the last forty years. There was evidently so little real ingenuousness in this statement, not that it was wrong, but simply that it was unenlightening, that the public set it down as not worth consideration, and continued to believe that fire insurance was very profitable . . . . The principle stated in words is as follows: besides the capital stock the company holds a surplus and an unearned premium fund; even a low rate of interest upon this sum of money will yield a large return upon the capital.

The 1911 report never said insiders should not manage to an underwriting profit; all it said was that outsiders need not feel obliged to measure to one.

We neglected that distinction. For the next half century we insisted and, perhaps worse, believed that investment income was irrelevant to both the regulation and the management of the basic insurance or underwriting enterprise. Thereby we

tied the moral and normative force of underwriting profit within our own organizations to its tottering credibility with the general public.

By the time we realized the separation had no external credibility, it had no internal credibility either, and insurance managers at all levels had all the reason they needed to justify underwriting loss by its ability to increase investable cash flow. That was too bad, because underwriting profit may be the best measure to manage by, being at once simple to understand and evaluate and yet roughly capable of trading off investment income against the greater capital cost of lines with long, and hence uncertain, loss development.

The second time the insurance business invited upon itself the horde of profitability measurers was in the late 1960s, when insurers felt trapped by their inherited presence in the ghettos and their subserviency in the nation's transportation system and when rates were no longer uniform and redundant but were, instead, the prize in public brawls whose incivility derived largely from superstition about insurer profits.

Then an industry with over 2,500 companies and over 200,000 middlemen had nowhere to turn but to government. And to address government it had to make a case for its own poverty.

Due in part to the embarrassment of its historical sleight-of-hand on investment income, the insurance industry turned to outside consultants for confirmation.

Confirmation duly arrived. Attacking and defending its methodology have spawned a generation of business school doctorates.

Certainly the controversy widened the gorge of incomprehension and mistrust between the insurance business and the representatives of the public. Most important, by sponsoring and publishing the study the insurance industry itself declared the legitimacy of measuring total profits.

None of this is bad. Indeed, scholarship is generally to be applauded. But here may also be occasion to recall the dangers of a little learning and of shallow draughts, as well as occasion to note that not in antiseptic and isolated ratiocination, but in living systems in living environments, are we measuring profits. In that reality is the gap between the reasons for asking a question and the consequences of answering it.

What will be the eventual results? What will happen when fundamental knowledge descends upon a set of arrangements, call it a business and a regulatory

system, so set against knowledge of that kind? Knowledge is indeed power, but it does not follow that the power inures to the first to inquire or the first to know.

Knowledge, rampant on a field of institutionalized ignorance, is itself an independent power. In it is the power to lure people to good intent onto the wrong issues and into enterprises fundamentally opposed in practice to what they fundamentally believe.

Given good data and sensible assumptions, the total past profit of insurers can be determined quite accurately. But total profit is the smallest major component of the flow of money through insurers, just as anticipated underwriting profit is the smallest major component of insurance rates. Moreover, it is a residual component, being what is left of gross income or premium income, as the case may be, after losses and expenses are provided for.

Finally, taking profit as a whole obliterates the very real qualitative distinctions, in the nature of risks and the demands upon management, between underwriting results and investment results.

For all those reasons, it would be a pity if our new found ability to measure scientifically the previous behavior of this small, residual and crude component of insurance costs should make anyone regress to the belief of cartel days that correct whole rates can be determined in advance with similar exactitude.

Such an outcome would be unfortunate anywhere. It would be grotesque where public policy is committed to competition among insurers at the consumer level, for there it would force, with a rather procrustean sense of fit, monolithic price regulation upon diffuse private pricing.

Insurance profit measurement would then become a painful demonstration that finance is not exempt from the law of physics that measurement alters that which is being measured. For the idea of scientific measurement has the power to lure any regulator of rates toward public utility rate regulation, toward a renaissance of cartels or shadow cartels to produce the one rate which can then be dealt with scientifically.

The concern is at least timely. The national government is today considering repeal or reduction of the conditional exemption of insurance from the antitrust laws.

That is all to the good. It would be a decade too late to be really exciting, save for the danger that it will mix badly with state rate regulation which, in turn, will mix badly with profitability measurement.

In the thirty years since antitrust became a real possibility, the property and casualty insurance business and its regulators have moved a long way toward

antitrust compliance—in two states with laws stronger than federal statutes, in one with the federal statutes themselves in force, and in many with no regulatory approval of rates and with markets rather than laws successfully making the business become more and more competitive.

Experience shows that insurance can live within the anticonspiratorial rules of the rest of the economy when given the independent pricing freedom of the rest of the economy. It shows no more.

Should the makers of national policy decide to hold insurance to the competitive norms of the rest of the economy, and to do so for real and for keeps, then they will have to deal with the business as it is today, with regulation as it is today, and with the temptations which misused profitability measurement would hold out for both of them today and in the future.

In insurance, we as a people would do well to decide emphatically that competition should police the competitors on price, and then dedicate our public energies to make sure that their competition is real and honest, fair to consumers and consonant with what we expect from the rest of the economy. Having done that, we should stay our public hand and our enforceable curiosity, and let the insurers make or lose as much as they will.

Specifically, if antitrust rules are imposed, by state or federal government, on the property and casualty insurance business, then, except in those few instances where competition will not work, no agency, state or national, should have the power to make or approve rates. For in a competitive marketplace the regulation of prices is, in the long term, at best an empty farce.

In the cerebral tundra of regulatory policy, we cannot find our way between competitive and standardized prices in many industries. We lack the omniscience to regulate totally. We lack the political grit to force real competition. As a result, we get essential private industries meandering into bankruptcy or nationalization, into crime or onto the dole.

In insurance today, what fascinates most is the possible collision of bravura antitrust law in the name of morals and anticompetitive regulation in the name of science. Against that likely disaster stand only a national government so often the graveyard of regulatory hope, states so often jealous of jurisdiction however trivial, and an industry most comfortable with freedom as an oratorical device.

If none of these improbable saviors stands firm for the proposition that price competition and price regulation cannot coexist, then their best service and that of the new science of profit measurement will merely be once again to memorialize the cost of answering too well, too late, one question too many.

The Shallow Draught of Investment Income

From time to time it befalls property and casualty insurance that its leaders, underwriters, financiers or regulators discover investment income.

Always the discovery is fresh and significant, free of any sense of having seen it all before. It draws crowds. It ends at best with frustration and usually in disaster. Investment income just does not have a happy history with us and, for the simplest of reasons, we appear condemned to repeat it.

In the prehistory of property insurance and in its age of sail, discoveries of investment income were rare. The insurance transaction itself was sufficiently new and unexplored. Much of what we now take for natural law in finance was lacking in scriptural basis, of doubtful legality, badly understood and too suggestive of class warfare and other breaches of etiquette to be welcomed everywhere.

Later on, those who intuitively understood investment income also had gained proprietary rights to the conventional ignorance. They dealt with investment income intuitively, which is not to say unwisely, by letting it sustain the capital beneath their art, retaining part and paying part to shareholders. Underwriting profit, large or small, belonged to the underwriters.

Sound insurance men did not encourage, and apparently did not themselves engage in, rigorous investigation of how investment income fitted into the entire business of insurance. They spoke in a language of words and numbers which would not easily support the necessary concepts. They could not have conspired to create an atmosphere more certain to retard thought, to arouse suspicion and to bring on recurrently the madness of crowds.

That is part of our lineage, although today insurance is often treated as a simple commodity business, existing only in the present and amenable to borrowed instruments of analysis. We commence to pay for our legacy of suppressed thought. Perhaps our predecessors would better have encouraged scholarship than maintained its subject to be non-existent or hazardous or both.

Investment income now being a topic of proper conversation, the next question is what we want to say about it. What is it? Where does it come from? How does it fit into the whole business of insurance?

The first two of those questions, properly understood, are really one. Investment income is income on investments. Against the background of the subject, that tautology says a lot. Most of all it says that investment income is income on assets which have been invested, not on assets somewhere else and not on liabilities of any kind.

Premiums written but uncollected may be good statistically and good for agency relations, but a company cannot earn investment income on them simply because it does not have them to invest.

Similarly, we should beware our slangy association of investment income with certain liabilities. With a blinding numerical precision we talk of investment income on the unearned premium reserve or on loss reserves. But only assets earn money. Liabilities do not, else beggars would ride.

Look at the insurance business. For a price, usually and mostly paid in advance, an insurer agrees to pay money in the future if something happens. The insurer never touches money equal to the full price, as some is intercepted by whoever sold the insurance, and the insurer does not touch the rest until the seller pays it over. When the money does arrive at the insurance company, it is set upon by those parts of the company which helped devise, prepare and record the insurance and those which keep the organization going.

What remains, which may be some seventy percent of the premium, is an asset available for investment and is indeed invested. How and in what it is invested is another full subject, encompassing such disciplines as risk analysis, portfolio balance, tax forecasting and numerology. For us here, the point is that what remains of the premium dollar is invested, but only when it is cash in hand.

An invested asset earns money in proportion to many things, most of which we have just excluded from consideration, but a remaining one is time. Ignoring the slander that a stock which is up today may be down tomorrow, it is generally true that the longer an asset is invested, the more it will benefit its owner by generating income which is either paid out or left to compound into appreciation in asset value.

How long does the insurance company get to keep this asset invested? Again the right answer is the simple one and the corollary of the answer to when the company could start investing. It has to stop when it has to cash in the asset to pay the proceeds to someone else. The longer the interval between collection and payment, the larger the investment income. Best of all are moneys which the insurance company never expects to cash in—moneys represented on the balance sheet by capital and surplus, whether contributed from outside or generated inside by underwriting and investment.

Now money is money, meaning it is all the same or it is fungible, and for the sake of analysis we have been speaking of accounting categories. But they are familiar categories and they have an important common character. Whenever they appear in financial statements, they represent money which the insurance company holds permanently or which is resting there a while on its passage through.

So seen, the questions what investment income is and whence it comes appear simple, as indeed they would be had we not complicated them by centuries of silence, occasional bursts of ecstatic or outraged noise and the entrapment of insurance thinking by the language supposed to express it.

The next question is how investment income fits into the whole business of insurance.

In the past we have tended toward one or the other of two opposed viewpoints. The first is that insuring is so risky that no asset should be put at serious investment risk as well. The second is that insuring and investing are two entirely separate activities, so that the investors of insurance assets should pursue investment return according to their own light. Of those two extreme views, the first may be thought of as the timidity of small companies and the second as the hubris of large ones.

Lately a sort of middle position has ascended. It is that in managing an insurance enterprise, one should regard total risks and total rewards, including premium volume, underwriting results, product mix and the balance, income and safety of investments.

Analytically, the approach is sound, indeed reminiscent of elegant risk-return modeling in portfolio selection. Given enough facts and assumptions, it can be carried through to an answer, or to a set of equivalent answers, with precision and without too much trouble. What it produces is interesting and can be useful in the service of high strategy. But for anything more dispositive or more visible in the marketplace, its allure is meretricious. We do not know how to handle it. Whatever its perfection as an artifact, as a tool in our poor hands it has two flaws, either one fatal.

The first flaw in total return theory in the practice of insurance is that it depends on quantification but does not quantify the danger of being wrong about costs, especially as they are related to future time.

The problem can be stated as one of insurance statistics. When given an unusual loss or other new event, we have to decide whether to treat it as just one more observation of an established variable, which would tend to increase statistical

certainty, or as the introduction of a new variable, which would reduce statistical certainty and perhaps change the mathematics of the whole exercise.

The decision how to fit the new event or piece of information into our system of understanding will often determine whether the system will be stronger or just better able to mislead us. The system itself cannot make the choice, but our inclination as insurers to equate numerous observations with knowledge will incline us to treat the new fact as just another instance of a known variable.

It is one thing to learn from dissection and quite another to confuse the dead with the living. Our devotion to the statistical past presupposes for it a knowable relationship to the future. Today in much of liability insurance the assumption is probably wrong, and certainly in those same lines we rely the longest on the assumption.

The same problem of uncertainty can also be stated in terms of our immediate subject, investment income.

Take the item which we call investment income "on loss reserves". If the longer an asset is invested the more it will earn, then the longer the assets represented by loss reserves are held, the more the investment income. In lately deadlier words, the longer the tail, the greater the investment income. This proposition, which is entirely true, can lead to some thrilling decisions as to product mix. For it assumes, by not addressing the question, that the reserved amounts will prove right when payment time comes.

The income on assets held against technical reserves may once have been extra income on what is known elsewhere in finance as float, with underwriting profit as a fee for the service of insurance. The old, crude system of pricing insurance, in which income and outgo were treated as though simultaneous, did not inherently favor either buyers or sellers—that depended on where its normative numbers were set. What the old system did do was treat all lines of insurance the same, which is natural since when it was devised only one line, fire, even pretended to analytical rating. Then the notion of considering investment income in ratemaking was meaningless.

Now, however, the intervals between collecting and paying vary widely among lines. To pretend today that the insurer does not get income from premium dollars in widely varying amounts as among lines seems as quaint as pretending he does not do so at all. Some insurance company or regulator is forever discovering this other income and using it to reduce the fee to be charged for the service of insurance in one line or another, especially in liability insurance. Unfortunately, the impatient competitor or regulator tends to overlook that this same investment

income was helping cover changes in loss cost patterns, changes which themselves change through time.

That a problem is essentially one of compound interest can be overlooked but, once recognized, it can be worked out as precisely for a long period as for a short one. But economic, legal and other changes in loss costs do become less predictable with time, so much so that at our present stage of social mathematics we may say that, further out than a year or two, they become unknowable.

A growing, uncertain, finally unknowable cost is and ought to be terrifying to anyone who will have to pay it. As the uncertainty and hence the fear grow with time, they somewhere surpass whatever the premium dollars may have earned during that same period in the less vertiginous world of investment. Indeed the very caution in asset investment which rightly accompanies heroic loss estimation just hastens that moment—the moment when the mysterious curve of compound fear overtakes the familiar curve of compound interest.

If we count investment income to bring prices down we should also count loss uncertainty to bring prices up. Today, offsetting the two should lead a rational insurer to charge the highest insurance fee or underwriting profit, not the lowest, for liability insurance—at least where the insurer is at risk beyond his confident foresight as to rules, claim incentives and price inflation. He should do so not because he is likely to achieve the intended underwriting profit but because he is not.

The second problem with total return theory in the practice of insurance is that it ignores the most difficult part of making anything happen in a sizeable, human institution—the leadership of people.

Insurance companies teem with people, many in jobs absorbing enough without the intrusion of such exotica as total return theory, loss development, investment income, current value accounting and so forth. They are the people who have the organization's future in their hands. They want to do what is right for the company, and probably a heartening proportion of them believe that senior management knows better than they what is right. When they do what is not right for the company, it is far less likely that they defied what they knew senior management wanted than that they did not know.

Give one of those key, front-line people a simple, immediate, concrete goal and, almost in proportion to his or her dedication, that goal will be met as it is understood. It will be met regardless of its wisdom and of its long-term cost in money and in less concrete values.

The most revered such simple, concrete goal is the combined loss and expense ratio. Like some older commandments, the combined ratio is proving so

difficult to live with that any sophisticate will gladly show you how crude it is in modern contexts. But it is central to the culture of insurance, and that culture is a formidable part of the real world of managing a successful insurance enterprise.

In that setting, give an insurance person a target loss and expense ratio softened by investment expectations and he or she, uninitiated to the supporting financial wizardry, will hear in the new, more tolerant ratio a directive to get business with a long tail and then will go out and buy it. Once that starts, insurance being insurance, it is hard to catch. Once caught, organizations being organizations, it is hard to turn around.

In insurance, total return theory can be a useful reference in the making of high strategy by a small group, but it cannot be shared—by design, accident or someone else's inference—with many people even in the management of the company without damaging and often very costly results.

For that reason, too, neither investment income nor investment growth can be used to attenuate the cycles in underwriting profitability. Small compensating changes in portfolio tactics are possible, with commensurately small effects. But large swings in portfolio strategy are apt to send dangerous messages through the organization—that management has given up on underwriting and is running a levered investment trust or that management can always make up for mistakes in insurance underwriting and pricing by occult manipulation of the portfolio. The gain, if any, would not justify the sacrifice in clarity and constancy as resources of leadership.

We started out with simple questions. What is investment income? Where does it come from? How does its fit into the rest of the business? In the process of trying to answer those questions we have, with fine impartiality, denounced the atavism of thinking about it too little, the scientism of thinking about it too much, and the arrogance of using it as though we had thought about it enough. Until we have mathematics adequate to simplify our complexity and until we have control adequate to inspire our freedom, we are at best left with common sense and all the magic gone.

Invested assets earn. Undelivered, uninvested assets do not. Liabilities do not. The longer an asset is kept invested, the more it earns, but if that asset is represented elsewhere on the balance sheet by a reserve liability, then the reserve had better be right. The longer the reserve stays up, the greater the danger it will be wrong, and that danger may compound at quite a different rate than investment income.

Assets should be invested to earn as much as possible, but limited by a prudent respect for the uncertainties and risks in the way those assets were gathered.

Managing to a grand balance of risk and return—unencumbered by respect for organizational complexity, for underwriting profit or for the chance of being wrong—is a good study but a bad religion.

Nothing is new here, except perhaps that investment income sounds simple. The description is imperfect and leaves us on our own more than is our custom, but investment income sounds simple because it is simple, not easy but simple, and making it sound complicated will not make it any easier.

The insurance business is complex enough that when we find a corner which can best be understood and described simply, we might rest content. We might admit to all audiences that investment income is indeed a part of the insurance business and has been all along. We might remember that it is and all along has been a supporting part of the insurance business and not the other way around, and that when we get it we do not get it for free. Finally, we might wish for all who touch insurance that they resist the temptation to be Midas, Marx or Machiavelli until they are away on safer ground.

The Commodity of Insurance

We insurance people often speak of insurance as a product, a modish word which does more to reveal our attitudes than to clarify our thinking. More accurately, property and liability insurance is a bundle of services—financial, engineering and legal.

The familiar physical product, the policy, is just the core definition of the services. Of the services, some, mainly dealing with avoidance of loss, are or should be available always and continuously. Others, such as legal defense or payment of money, are provided only if some event, foreseen in the policy but uncertain of occurrence, indeed occurs.

This bundle of services which we call a product can be very complex, subtle, hard to measure and variable with circumstance. Yet, oddly enough, in the marketplace some of it behaves like the extreme opposite—a commodity.

* * *

What is a commodity? What does it look like? What are its physical properties? Does it not leave soot, soil, rust or dung on the hands?

Not necessarily. We are used to thinking of commodities as products of the farm, the mine or the mill. But the notion of a commodity has not to do with the physical nature or origins of an economic thing and certainly not with its simplicity or sophistication in our eyes. It concerns how the thing is treated in the market.

Consider the word itself. "Commodity" suggests convenience, surely not of the thing but of the user. A commodity, in its paradigm case, is an economic thing controlled by the requirements of its consumer. Conversely, it is an economic thing whose producer's identity does not matter. A commodity is an orphan.

Now money is obviously a commodity, but the ways of handling it are equally obviously not. In parts of the insurance business, as in parts of commercial and investment banking, one seller's handling of money and his design and provision of the attendant services are seen by enough buyers as quite unique. They then cannot compare his offerings with others solely on the basis of price and he, in turn, can somewhat control both his prices and his selection of distributors and customers. A happy, useful and usually most profitable situation.

But elsewhere in insurance—whether defined by line, market or the mainstream of companies—those differences do not exist or are not appreciated.

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There, insurance displays the thin profit margins and cyclical earnings common in a commodity business.

* * *

The commodity side of the insurance business has a long, ironic history.

During the last half of the nineteenth century, the great fire insurance companies and the makers of public policy in the several states were pulled between two opposed ideals of market conduct—the board or cartel with uniform rates enforced by private or government cartel offices and, at the other extreme, antitrust or, as they were called, anti-compact laws prohibiting agreement on rates. The first principle was in the name of stability and solvency, the second in the name of competition.

Shortly after the turn of the century, the private and public policy decisions drifted toward the regulated cartel model. From then on, the participating companies, agents and governments all had an interest in standardizing the bundle of services which we call the insurance product, that is, in making it a commodity in the economic sense. Only in that way could the cartel (plural in organization but singular in effect) control prices and underlying costs, so as both to achieve its purpose and to perpetuate itself.

Part of the irony is that the very standardization of certain kinds of insurance protection, and the very uniformity of rate, offered an opening for lower cost companies to go after business on a pure price basis if the law allowed them to do so. Those companies tended also to be skilled at marketing, either generally or to restricted or self-selected groups of (as it turned out) superior risks. They were quite a threat to the establishment once the legal barriers to price cutting were breached as, of course, they were.

The parts of the insurance business which have the most characteristics of a commodity business are now well on the way to being dominated by those lower cost, skilled marketers. The process is one of developing skills and transferring capital and allegiance. Hence it is gradual. Its very existence has been obscured by the growth in total insurance sales. The national stock agency companies are gaining sales every year, just as surely as they are losing market share.

The gradual change in selling the commodity of insurance is not over. The number of participants from the marketing culture is increasing. In addition to the familiar successes, coming now are large life insurers seeking new income for their salesmen, store chains seeking new products to put on their shelves at a discount, and subsidiaries of large industrial corporations seeking new uses for excess capital.

The currently dominant marketing companies as well as the new entrants are not so much underwriters as they are sellers. They are used to competing on market analysis, location, advertising, packaging, price and endurance. Individual risk underwriting is hardly irrelevant to them, but they are probably better at it than they need to be.

The marketers benefit from an apparent human tendency to insure against higher probability, low to medium severity, losses. The old cartel companies, whose folklore is based on utility theory pointing just the other way, do not. In short, the new marketers stand to benefit from the standardization, especially in a stripped down form, of the bundle of services called the product of insurance.

Today it is they who stand to benefit from casting or keeping as much insurance as possible in the commodity mold, for success then will depend on their kinds of skills. Where insurance is regarded by the ultimate consumer as a commodity, the marketing firms will be remorseless competitors, perhaps in the long run vulnerable only to each other. When the last antelope is eaten, the lions must die—or move on.

* * *

This is not the first time in business or elsewhere that establishments have assumed each other's roles and each other's attitudes. The process is often ironic and never painless. The central irony here is that the old cartel companies, having spent the better part of a century making insurance into a commodity, must now seek salvation in unmaking it so. Yet they do not always act that way. Witness the common attitudes toward solvency, regulation, distribution, pricing, economic and social stability, and differentiation of the bundle of services known as the insurance product.

Those six attitudes, none of which is in their present or foreseeable best interest, are best understood in the context of a commodity cartel which no longer exists.

First as to company solvency, the disappearance of a member other than by happy acquisition was rightly regarded as a sign of weakness in the cartel. Setting rates high enough to protect inept competitors had benefits for everyone. Regulation for solvency, depending heavily on limiting writings in relation to surplus, also inadvertently provided an ingredient essential to the fire insurance cartel or indeed to any successful commodity cartel—a means of controlling supply.

Today government has taken the position that the public, in its role as small policyholder and claimant, should not suffer from insurer insolvency. Whether government or the stronger members of the industry will go further is less clear. The reflex to prevent failures is still strong, as was recently demonstrated in a

conspicuous act of—depending on your point of view—statesmanship, suicidal altruism, or what is sometimes called the law of too horrible to contemplate.

Related to the counterfeit equation of insolvency with collective failure is our preoccupation with government regulation, a preoccupation which tends to be self-fulfilling, debilitating and addictive. After so many years of looking to government to shield our transactions and to help control competition, the preoccupation is understandable.

What is remarkable about our fascination with government is that government directly affects our choices as to product design, distribution and pricing in only a relatively few areas. Outside of personal automobile insurance and worker's compensation—the first a classic commodity with social insurance overtones and the second a classic social insurance with commodity overtones—the regulatory changes back and forth today seem to make little difference.

Distribution preoccupies us because its cost was the first justification for price cutting, the first opening for the marketers, and the first activity to reveal that the fire insurance establishment's long efforts to make insurance into a commodity were about to backfire.

Fourth is the obverse of price cutting—mechanical, steady and visible rating. In fixing a price, it helps to know what the price is.

Rate rigidity is maintained by inherited rates as in fire and surety, by the normative force of statistical credibility, as in automobile and worker's compensation, by government price maintenance, as in title, or by political suppression, notoriously in personal automobile but potentially in any other commodity line viewed by the public as a tax.

A fifth legacy of the cartel mind is well caught in the plea that insurance must have a stable economic and social environment in which to function. On the record, it is hard to deny that insurance companies do poorly when they encounter economic and social changes they did not anticipate. They should.

The business of insurance is not to depend on social and economic stability. It is to create economic stability for others in the face of uncertain misfortunes of all kinds—negligent, capricious, malicious or divine, not to mention social and economic. If mankind were to take seriously our protest that we require to function that which it is our function to provide, the logical consequences might give us even more to complain about.

The last of the six leftover attitudes is toward product differentiation or, put in better historical order, the tendency of our business to deal with insurance as a

commodity like so much oil, timber, steel or computer chips, and thereby to make it so. The cartel required this, perhaps above all, for its own efficacy and survival. For to agree on a price and to enforce the agreement, it is necessary that the common price be of a standard thing.

* * *

Those six heirloom attitudes tend to distract us from what is really going on in the deepest economics of our business, and that is the shift in its commodity portions from cartelization to marketing.

When commodity cartels break down, the law of supply and demand, just as we were taught in school, begins to function. It functions without statesmanship or chivalry, which are no longer affordable, and without price leadership or other unspoken, cultural restraints, which has had no cause to develop. It functions through ferocious price competition, with prices driven below the marginal costs of all but the most efficient competitors. Much later, the efficient survivors are shocked at how much their remembered profit margins depended upon the presence of less efficient sellers in the same market.

The agricultural, mineral and industrial commodity businesses are characterized by violent swings in supply, demand and price, obviously affecting each other and repeatedly squeezing all profit and enjoyment out of the enterprise.

It seems likely that where insurance is a commodity, the business will now behave the same way, perhaps more violently because of its unavoidable ignorance of aggregate as well as unit costs. That these gyrations will cause stock market alarm and public outrage is obvious. That they will hasten the consolidation of and exit from the business is subject to the aforementioned law of too horrible to contemplate.

* * *

Conditions of general instability in the insurance business, which may last several decades, will surely bring unusual opportunities to the few companies able to take advantage of them. It remains now to try to identify in advance the characteristics of those companies.

They will either be commodity marketing experts with low costs and great staying power, typically the best direct writers, or they will be other companies which were able to move away from commodity areas or at least from commodity thinking, most likely the best independent agency companies in cooperation with agents and brokers of like mind.

For the second group, competition will not be in pricing down a commodity but in providing the insured with protection or a financial relationship which he

cannot get, or cannot get as well, from another provider. Those companies will have in common the establishment of continuing relationships between insurer and insured based on a shared understanding that the insurer, producer or both can provide the insured some combination of loss avoidance and loss compensation uniquely appropriate to his way of living or doing business.

The differences may be in policy design, loss prevention, loss settlement, engineering and, of course, willingness to take unusual risks, to provide broad or narrow coverage depending on the needs of the insured and, once enough customers are available, the ability to choose among them based on fine intuition or great knowledge of the subject matter or particular risk.

Idealistic distinctions between real and perceived difference are of no use here. Outside the marketing group, no one company has the market position and advertising power to work directly on the mind of the ultimate consumer, and since differentiation is basic to success for those other companies, collective marketing is unthinkable. Their only chance at durable, profitable differentness is to offer coverage and service which speak for themselves, and which the customer, producer and company all believe to be different, superior and hard to copy.

People need help with misfortune and uncertainty, and they are willing to pay for it. They are neither so dumb as to expect something for nothing nor so docile as to accept nothing for something. In the long run, they will get what they pay for or they will only pay for what they get. They will allow us to transmute their fear into our gold, but only if insurance reflects their view of their needs. The most precious capital of an insurance company is social, not financial.

In the future, where insurance is not deliberately uniform, it will have to be deliberately different. Where insurance cannot succeed as a product, it will only succeed as a relationship between thoughtful sellers and thoughtful buyers. The relationship will not be especially sensitive to price, because thoughtful buyers know that superior understanding, loyalty, imagination, nerve and financial strength are not commodities.

Success in the new world of insurance will call for the long, patient eye of the proprietor in the complex, urgent world of the managerial corporation. It will require the courage to resist pressures for conformity built over a century of making insurance a commodity to support its cartel, as well as the grace to concede that no organization can be superior in all lines and markets. It will come to those with the imagination to serve uniquely and the pride to require good payment for their service. It will be most rewarding, for the right reasons, for those present to enjoy it.

Capital and the Market for Insurance

A few years ago, insurers cried poor of capital. For emphasis they raised rates, canceled policies, pulled out of risky lines and on occasion even gave their agents a hard time.

Among those who got the point were the customers of the insurers and their business and political representatives.

Among the responses were insurance pools, cooperatives, specialty writers, self-insurance programs and adventures in regulation, reinsurance and the management of cash flow.

Customers and their business representatives also reached into the industrial economy for capital. Insurance brokers brought into the general insurance marketplace companies which we used to call captive insurers, and they are apt to stay.

Our late dalliance with poverty has thus had lasting effects. But its significance is not just in the infusion of capital for insurance.

To see what has come about and where it is likely to lead, let's look back at how insurance has been sold and at what capital has meant to the market for insurance.

In the first half of the nineteenth century, American insurance companies which wrote fire insurance or marine insurance wrote it directly.

We think of direct writing as a new way of marketing insurance in this country. Instead it was the first way. Why?

Perhaps we should ask why not. It happened that way because the American economy of the time made that the natural and easy way.

In the early nineteenth century, the American economy had plenty of opportunity but not a commensurate amount of capital. Any promising activity which needed capital had to compete with other promising activities.

Insurance seems to have been first tried without capital. With truly occult skill or a providential run of luck none is needed. That fact was not lost on the optimists of the early American insurance business.

The bankruptcy record of the early American insurance business testifies, however, that more was required than the booster's faith and the gambler's dedication.

At the middle of the nineteenth century, more and more customers began to ask about the financial condition of insurance companies. The states began to assert that insurance, originally meaning the financial condition of insurers, was affected with the public interest. The company with capital was seen as the one to do business with.

In the mid-nineteenth century American individuals and businesses came to the well financed property insurer. It did not go to them.

The supply of insurance, limited by the capital behind it, was the crucial factor in the marketplace. It was a classic seller's market. Access to customers meant little. The challenge was taking care of the customers already at the door. Who then would pay an independent middleman for bringing in more customers?

There we have the economically compelling reason why property insurers began as direct writers. What changed?

What changed was the creation of a national economy in a continental country. The economy began to shift from the coastal centers to an advancing edge and a vast territory filling with people.

The territorial economy needed insurance, but the insurance companies were not there. They could not be everywhere, and everywhere was the marketplace.

If insurance companies wanted to do business in the vast territory, they needed access to it. Access could only be had through people already there—the feedstore owner, blacksmith or banker.

The local merchant doing an insurance business on the side knew his community, knew what his neighbors needed and how they behaved. He underwrote through his own eyes. The distant insurance company would best give him its pen.

In the last half of the nineteenth century, the insurance agent was what we would call a general agent. He arose for an economically compelling reason. If companies wanted to do business in the heartland, he offered the easiest, perhaps the only, way to do it.

But did the companies want the business which only the agent could offer? What about their lack of capital to handle business coming to them in more familiar ways?

Once securely started, and barring only the worst price wars and natural catastrophes, property insurers proved to be remarkable machines for generating capital. Insurance is one of the few parts of finance in which the customer is at least intended to pay the financier a fee for service and also to let him keep the income from investing the customer's money.

A well managed insurance company ought, therefore, to be able to accumulate capital out of retained earnings fast enough to support a well managed rate of growth. Indeed faster, and that has been the record.

In the late nineteenth and early twentieth centuries, property insurers were financially ready for new business from the American heartland. Only insurance agents on the scene could possibly supply it. The American agency system was as natural as direct writing had been before.

Since then, the main story of our business has been in the growing importance of efficient access to customers and in the diminishing importance of cartel pricing as a substitute for capital.

The next chapter in the story of capital and the market for insurance will involve the answers to three questions. In light of our historical survey, we can see that the questions are tightly related.

First, is there and will there be a shortage of capital for insurance? The answer is no.

Second, are structural changes now under way which are comparable to the direct writer movement begun a half century ago? The answer is yes.

Third, is the balance of commercial power shifting as between sellers and buyers of insurance? The answer is yes.

Three years ago we waited for the capital of insurers to be restored, voluntarily or otherwise. Scarcely had the eye of investment banking shined when new capital indeed arrived, though not in the ways expected.

Capital or its equivalent came from overseas, from life insurers, from an acquaintanceship with leverage and from a greater willingness to self-insure. Most important, it came from new insurance subsidiaries of old industrial corporations which had, for the moment, more financial resources than they cared to use in their traditional work.

Defying predictions that they would be short of capital and perhaps defying their own data, the industrial corporations acted as though they had too much and not too little money to put at business risk. Without enticement in their own fields for fast expansion and hounded by inflation not to expand slowly, they either contracted or looked elsewhere, using their excess money to buy themselves or to buy each other.

To them, an insurance industry crying poor of capital should have looked attractive. But right after the most vertiginous cycle in its cyclical earnings history, it did not. Industrial companies did enter the insurance business, but only with eyes downcast.

What became diversification began as sophisticated purchasing. The industrial companies brought to their traditional insurance needs the financial analysis used in other decisions whether to make or buy. Sometimes they decided not to buy.

At first the captive insurer was what its name suggests—a vehicle for its parent's decision not to buy. Then came taxes, ambition and the merchant grail of more green money on the other side of the fence. Captives came to the general insurance marketplace, hurrying for customers.

In the future as in the past, insurance companies will usually be able to generate their own capital. But when they cannot—or when they think they cannot and act accordingly—more capital will come in from outside. Putting capital into the insurance and reinsurance businesses, or into making them unnecessary, is and will be quick and easy.

The changes in capital have led to changes in the structure of our business, to an integration of client contact and risk bearing.

From the beginning, the independence of the American agent, even more than his skill, has been his distinguishing quality. The American agency system contemplates three independent participants in the insurance transaction—the insured, the middleman and the insurer. It is a system of balance and tension. It thrives on a balanced importance of capital and markets.

Where either capital or market is conspicuously more important than the other, the system seems to prefer two rather than three participants. An example was in the early nineteenth century, with a capital shortage and insurance written directly.

A contemporary example is where client contact is routine, and exposure control and capital conservation are aided by masses of standard data. Efficient

access to customers becomes most important. There insurers have integrated forward to gain simpler and more controlled relations with customers. An example is personal automobile insurance.

Similarly, where an agent, broker or association represents many similar customers for a standard coverage, they often integrate backward to risk bearing through formation or control of an insurer. An example is worker's compensation.

The latest attempts to integrate backward from client contact to risk bearing are in heavy commercial casualty and medical malpractice. If they succeed, it will not be due to the ability of the operators, typically large brokers, to do everything a large insurance company does. Indeed it will be in spite of their inability to do so.

The latest moves toward integration in complex commercial insurance testify to the importance of orienting a service organization toward the client being served, so that it knows the client's business and not just its own. They also testify to the consequences for agency companies of having let a brief scare about capital adequacy lead them to act as though they were back in a seller's market.

For they overlooked our third question, the shift of power from the sellers to the buyers of insurance. In mature capitalism—where an open market allocates resources in a service economy—insurance is usually a buyer's market.

In a general buyer's market, momentary frights over insurer capital tend to enlarge the roles of cooperatives, specialists, big brokers, risk managers and direct writers. They have to stay in the markets which fathered or sustain them, and will simply take bigger chances or reach for capital somewhere else.

For stock agency companies, with more mobile capital, pulling out of markets leads not to remonstrance but to replacement. We can no longer make people do without insurance. We can only make them do without us.

Understanding the history and economics of insurance was once unimportant to practitioners. Perhaps it was a social grace, a mental decoration, but it bought nothing on the streets of business. The reason was that the economic fundamentals—the seller's market and the anti-competitive arrangements with which it was entwined—were so powerfully favorable to insurers and agents.

So much now is changed, even reversed, that we must beware of that tradition. It now pays to understand the economics of our business.

If we analyze our fears of capital shortage, they will go away. If we understand the reasons for integration backward, we will better exploit or defend against it.

Most of all, if we recognize we are in a buyer's market, we will not wait for great economic forces to drive customers to us on our terms. The good days ahead will be different from the good days on the insurance prairie, for we are now finally working for the fellow we always said was right.

The Tides of Hazard

Insurance companies feel misunderstood. They state their beliefs and are judged tedious. They shut up and are judged secretive. Journalists poke fun at them. Regulators chase them about.

Insurance companies and human beings indeed can have a strained relation. They are not, after all, brought together in life's happiest moments. They trade in fear and grief, in ashes, blood and money.

The strain is natural. But it is unfortunate and unnecessary. Of all our great business institutions, insurance is perhaps most intimately involved with people individually and with people as a society. Both society and the insurance business affect how well the other functions. Crucial to both is that they have complementary objectives.

Insurance is involved with society in many ways, but three are fundamental to whether insurers will prosper and be useful and content.

First, the business of insurance works best when the insurance bet that an unfortunate event will not happen is supported by private and public decisions that the event should not be allowed to happen. Insurers assist society's effort by making visible the costs of the event, and they benefit as the event is brought under control.

Second, insurance works worst when it is betting against society's efforts. That can happen with the insured event itself, but these days it is more common when society sets out to shift the cost of the unfortunate event from the victim to others and insurers stand against the trend.

Third, private insurance can end up working not at all when the insurance mechanism itself becomes the main object of society's efforts to deal with the costs of unfortunate events.

Let's look at those three kinds of social involvement one at a time.

When society is trying to suppress the insured event, the reasons insurers tend to do well is simple. Insurance prices begin with a reckoning of past insurance losses. If society succeeds in its efforts, then losses, measured against the values or activities insured, will decline over time. The losses of the future will be lower than the losses of the past. Prices will consistently exceed the related costs, which lie in the future. The difference will be profit, capital generation and the desire to write more insurance.

The trend which matters here is in insured loss costs compared to the economic value of the property or activity insured. When losses in that sense are declining, doing an insurance business will resemble what is known in the computer business as riding the downward cost curve.

Such changes will occur over long periods of time. They may be likened to tides. Insurance cycles, like waves, will come for other reasons regardless of which way the tides are moving.

There is quite a record of these tidal trends in insurance losses and of their effects and causes. Here are some examples.

Life insurance is the clearest and best known. For three hundred years rates have been based on tables of past mortality. Meanwhile, lifetimes have lengthened due to better diet, public hygiene, medical care and working conditions. From time to time the mortality tables have been made more recent, but it has never been their function to anticipate.

The fortunes made in life insurance in the nineteenth century are often described as triumphs of salesmanship. They were that, but it is important that what was so expertly sold was also so consistently overpriced.

The examples are less obvious but no less real in property and casualty insurance.

The oldest line of insurance is ocean marine. Nineteenth and twentieth century improvements in ship design, navigation, seamanship and the stowage of cargo made voyages safer and safer. Ocean marine rates tended, therefore, to be too high. Insurers prospered, as they did later when insuring aircraft.

In fire insurance, rates proceeded from an astute judgment a hundred years ago about burning costs. For a long time thereafter rates were not modified by experience at all.

Construction improved, with fire resistance prescribed by law. Supplying water and fighting fires became duties of government. Fires happened less often and were less severe. By habit and agreement, rates stayed the same. Money was made.

When workers' compensation was introduced in the early twentieth century, its mysteries called forth a new statistical science. Doctrines of credibility required much past experience for making future rates.

Meanwhile, industrial safety improved. The number and severity of injuries went down. As long as benefit schedules and claim attitudes remained the same, the effect was to bring insurance losses down too. Credibility theory stayed the hand of

the rate cutter. Experience in workers' compensation was favorable for many, many years.

The pattern holds in the largest property and casualty line of all. Since the first world war, automobile insurance losses, in relation to the number of vehicles and miles driven, have been going down.

The reasons were better roads, better cars, two wars, a depression and an assimilation of the car to our national character so complete that it became the only appliance to be taught in the public schools.

As the unit cost of auto accidents came down, so did insurance rates. With perfectionist actuaries and imperfect competition, the decline was unhurried.

This happy condition endured until the breakup of the pricing cartel and the price pressure of the direct writers took out of automobile insurance the general or sociological profits. Getting back on the downward cost curve through exquisite rate classification, tried at one time or another by all types of companies, has not been as easy as it looked.

Yet even here the problem is economic. The physical trend is still probably favorable.

This survey of downward loss trends leads to the question why they occur, why the insurance bet and the social resolve so often support each other.

The question leads back to the observation we started with. Insurance is an intensely social institution, reflecting what people do and make, own and think.

The same events and worries which call an insurance into being and make people want to buy it may also animate people in other ways.

People may demand other protection from what they fear, be it sickness, death, injury or the destruction of property. They may move government and other institutions to protect them. When that happens, the same alarm which created the insurance will have started a greater effort to control the insured event.

The effort may be public or private, coercive or voluntary, coordinated or diffuse. It may involve penalties, subsidies, warnings, encouragement, prohibitions and the whole regulatory array. When a private misfortune becomes a public concern, society has a lot of resources.

Insurance, in turn, helps society by informing it in advance of likely future costs and savings. The record is long—iron hulls and safe stowage, sprinklers and

fire alarms, guarding machinery and rehabilitating the injured, safer grain dryers and safer cars.

The insurance business benefits from society's effort to control the insured event. The business assists the effort by making the cost of the event clear in advance. The relationship is symbiotic and stable, pleasant and profitable. It belongs in every glorification of free enterprise.

Not all insurance loss trends, however, are downward. Tides can run both ways. Here is the second engagement of insurance and society—opposition.

Sometimes the problem is just that coverage is so designed that costs go up instead of down as society achieves its goals. Obsolete mortality tables have done little for annuity companies and pension systems except cause trouble.

But there is a more complex, expensive and, thus far, intractable example of the second or adversary involvement of insurance with society. It is where society is trying to reallocate costs through the insurance mechanism and the insurance business, rather than staying neutral and just holding the stakes, is trying to stop society from doing so.

Exactly that has happened in the last ten or twenty years in liability insurance. The immediate cause is not, as is commonly supposed, the ingenuity and aggressiveness of the plaintiffs' bar. Plaintiffs' lawyers have been trying to broaden the rules of recovery from time immemorial. What is new is that in the last couple of decades they have begun to succeed in a big way.

The deeper reason is that, in liability insurance, not one but two social forces are at work. As far as insurance is concerned, in recent years the two forces have contradicted each other, and lately the second has overwhelmed the first. Here's how.

Insurance losses involve an event and its financial consequences. Typically the event is physical—the blast, crash, fire or death.

In some classes of insurance, the event is connected to its financial consequences only by contract, the insurance policy. That contract is the decisive social arrangement. Changes in interpretation will tend to be gradual, because society has an important interest in consistent and predictable enforcement of what people agree to.

Where the link between event and consequence is simply contractual, long trends in losses will depend mainly on the physical event. As society controls the event, the benefits will flow directly into the insurance system through declining

losses. That is true today in life, health, property and marine insurance and in bonding.

But in the liability classes, the event is connected to its financial consequences not just by contract but also, and more importantly, by the system of civil legal liability or tort.

In the United States, with much individual freedom in personal and economic behavior, the tort system is an important way of allocating costs and limiting behavior. Like our other social institutions, the tort system will change over time in response to the citizens who operate it and to pressures from outside.

Where the tort system connects the physical event and the financial consequence, society can modify not just one but both steps in the insurance loss. It can suppress the event and it can make the tort law link more or less generous.

As long as the tort rules remain the same, regardless of their level of generosity, insurers can stabilize and cover their costs. The benefits of society's control of the insured event can flow unimpeded into the insurance system just as in first party lines.

The conventional statutory, contractual, underwriting and rating techniques for stabilizing and covering liability costs were developed at just such a time, one when the rules did remain the same.

Yet the very apprehension and sympathy which created the demand for insurance and moved society to control the insured event can lead to an expansion of the ability to shift losses. That has happened in recent years and it continues. The tort law link becomes more generous.

Consistent and predictable interpretation of the insurance contract gives way to society's stronger need to fund the changes in the tort system. Brushed aside is the legal artistry of the insurance contract, now seen as printed by the strong for the weak to sign.

Part of our problem with the tort expansion is psychological. In the past, we not only allocated costs but we also understood the rules of allocation and even had substantial influence over what the rules were. We wrote the insurance contracts and, by and large, the courts respected them.

Now society has taken over the design of the cost allocation rules. It does so by uneven judicial decisions. We insurers still pay under the allocation rules, but we no longer make those rules or even know what they are.

Suddenly powerless and frustrated, but still quite human, we lash out. We identify as the problems society's effort to shift accident costs away from initial victims and society's effort to internalize to economic activities their accident, health and environmental costs. We change from society's stakeholder to its opponent.

Opposing such tidal change with the conventional legal and pricing techniques developed in calmer times has cost the insurance business a lot of money. Society wants to shift more, not less, of the costs of the unfortunate event, and betting against its ability to do so has about as much chance of success today as betting in favor of fires would have had a hundred years ago.

Futile perseverance in the second, or adversary, relationship with society sooner or later leads to the third—where insurance itself becomes the main social or political issue.

Recently we have seen it happen in property insurance in central cities, health insurance for the elderly, surety bonds for minority contractors, liability insurance for physicians and automobile insurance for people rated up for reasons beyond their control.

What those instances have in common is sudden change and a public view of insurance as an unsympathetic but not inaccessible part of the problem. Their common danger is that society will go feverishly to work, not on the insured event but on the insurance mechanism.

The debate can shift away from the cost and control of hazardous behavior and toward questions of who wins and who loses and who gets to make the big decisions. Once society's concerns take that form, it is rare indeed for private insurers to come out ahead.

The best hope for private insurers is that the social debate never center on them. Avoiding the third involvement with society depends on success in the other two, on being recognized as naturally supportive of what society is trying to do about unfortunate events and their costs.

The three powerful social forces—to suppress the insured event, to transfer its costs, and to compel insurers to spread them strangely—spring from similar human concerns. They come together intricately, changeably and with great impact on insurers.

Let's turn again to examples.

In automobile insurance, for over forty years critics have been asserting that insurance has no role in suppressing the insured event, and that shifting its costs through the law of negligence is inefficient and unfair. The proposed change has

usually been to omit shifting the costs notionally to another individual before spreading them through insurance. Ten years ago it looked as though society was marching that way. Now the question is back in doubt and, ominously, society's attention has turned to the practices of insurance companies.

In fire insurance in central cities, just over twenty years ago experts looked to the high cost and limited availability of coverage as a useful spur to owners to fix up their buildings. Insurance was to be used to price the insured event out of the market. A decade later, urban riots and a different way of looking at urban decay made insurance itself the central issue. Insurers were forced to spread the costs, to make property owners elsewhere subsidize them and, one may suspect, to encourage them to happen.

Today, the kinds of insurance in which the interaction of the three forces is most confused and the outcome most in doubt are both commercial casualty lines—professional malpractice and product liability.

The setting is not auspicious. In commercial casualty insurance in recent years, money has been made not by the bearers of risk but by those who distribute it. For the insurer assuming exposures on a net basis, even the investment income on the longer asset float has not overcome underwriting losses, let alone generated capital to support growth.

Instead, profits have gone to brokers, whose commissions have risen in proportion to premiums, and to insurers with books of business balanced between primary exposures and reinsurance. Both have achieved entrepreneurial stability, while actuarial stability has eluded everyone. Perhaps it is a sign that a business is both exciting and unsound when all the profits are made by arbitrageurs.

Yet in malpractice and product liability, everything seems to be happening at once. Society is awakening to the prevalence of the insured event and setting out to suppress it. Society is also encouraging the transfer of costs from victims to perpetrators. At the same time society is inclining to look upon insurance itself as part of the problem.

We insurers are not strong enough to resist any one of the three powerful social forces converging on the more troubled parts of liability insurance. Fortunately, all we need is a little inventiveness and an ability to assess how the forces will come together, for given a correct assessment we can relinquish our partisanship about the outcome and get on with the business we know—accepting risks which all can see but only we can bear.

What once upon a time we insurers found in property insurance, we must now create in casualty. For if we can just solve the riddle of how to insure expanding

liabilities for contracting events, we will add them to the pleasures of the downward cost curve. Conversely, if we do not figure out how to write liability insurance in a way that assures stable markets for our customers and generates capital fast enough to support our exposures, we cannot expect forever to remain independent of either our customers or the government.

In summary, insurance made its first money in natural harmony with social progress, helping man tame hostile nature.

Then came accidents and questions of blame. We admit with small grace the inevitability of accidents—in the car, home or factory. But to get the kind of society we wanted, we made a tacit decision for accidents.

So insurance the adjutant of progress became also insurance the harbinger of the unmentionable costs of progress.

Caught between the America of the strong arms and the America of the huddled masses, how could insurance not itself at times become the issue?

All three trends, the ones we like and the ones we do not, are parts of the same society. We cannot take one without the others.

Nor can we demean our problem as nostalgia or futurism. Certainly some losses came down because American at one time let nothing stand in the way of economic growth. Certainly some have gone up in the interest of fairer allocation of resources now viewed as finite and only slowly growing. But the insurance business, inventive as it is, need not be just the messenger and victim of such obvious historical changes. If we can think, we surely have the freedom to act. We are not on, and do not belong on, the hidden agenda of any utopian socialist.

To succeed, to get back on the side of history, we insurers need first to acknowledge how very social an institution we are. Our problems and uncertainties are social. The gravity of our condition is not physical. The physics of our condition are not grave.

Once we understand who we are, and see both the greatness and the smallness of our role, we will find ourselves moving with the most powerful tide of all. It is the great effort by our society to reduce the unfair risks of living, to reduce the harm done by those risks, and constantly to broaden the concept of what risks are unfair.

Once back where we belong, we will be in funds and be in grace, and we will find that our most basic and most successful bet was to take civilization as our partner.

Profit, Time and Cycles

The free exchange of ideas may eventually lead to the exchange of professions.

Securities analysts, who ten years ago found truth by dividing reported earnings into stock prices, are now bent over Schedule P. Actuaries, once confined to rates and loss reserves, now discuss total return and the latest inspirations in portfolio theory.

Is the conclusion that both professions have had a rough decade? Perhaps, but a more appealing alternative is that both are trying to understand more about insurance finance.

We are trying to understand how risk-bearing insurance companies work, both as parts of the larger economy and as businesses themselves.

Before going further, it is good to emphasize that that is all we are doing—trying to understand better. The casual transfer of what we learn into either short-term management or normative regulation is far more likely to be foolish than the analysis is to be wise.

That caution stated, let us talk generally about insurance profits, although perhaps in an unusual way. It will naturally lead to a look at the reasons for variability in profits and particularly to a look at the underwriting cycle.

Insurance has built up over the years a language of words and numbers which is quite useful for running a company and regulating it on a daily basis. But the language gets in the way of systematic understanding of the individual firm and of the business as a whole.

That is particularly true with respect to the significance of time. The accepted insurance language began by ignoring time, treating income and outgo as though they were simultaneous and hence keeping underwriting and investments in two different worlds.

The reasons are surely more historical then sinister, but as a result our thinking is imprisoned by a set of concepts which make it very difficult to synthesize what is going on in the whole operation.

The trouble turns up in the perfectly sensible effort to bring time into the picture by attributing investment income to different lines of insurance.

A humorous example is our speaking of investment income on reserves, as though liabilities could be invested at all. Easier to overlook is the unmanageable snarl of cash and accrual accounting, hard and soft numbers, income statement and balance sheet categories, and so forth, with which we try to work.

Finally, our attempts to arrive at total return by line lock us into measurement periods which we sense, correctly, are absurdly short. They lead us into metaphysical disputes about the earning potential, verging on the moral quality, of money one gets to keep forever compared to money one has to pay back.

If we are willing to step away from our inherited insurance concepts, understanding how profits are made gets a lot simpler. Then an insurance company can be explained in terms of just two ideas—earnings on funds invested and the cost of funds.

A representative policy is sold. Premium, net of commission and underwriting costs, is collected and invested. It is probably invested in a security, for simplicity say a bond, which earns interest at a fixed rate. Our accounting conventions and investment habits let us simplify further by ignoring bond market fluctuations, so the investment return is indeed fixed.

From time to time losses and further expenses are paid under the policy.

If we close accounts on the policy after a year, we simply deduct the losses and expenses paid from the premium and interest collected.

If we wait, then after a number of years, the loss payments cease and the books can be totted up. We find that the invested assets and their compounded earnings have been offset by losses and expenses.

If the offset is more than the original investment, then in other financial contexts we would say that we have had to pay for the temporary use of our investable funds. If the offset turns out to be less than the original investment, we have had a negative cost of funds which, instead of being deducted from the investment earnings, is added to them.

In either case, the sum or difference, if still a positive number, would be the total return, which could then be adjusted for time by discounting or some other technique and compared with whatever resource one was measuring return upon.

For an imprecise but perhaps comforting invocation of insurance terminology, we are speaking of total return on a fully developed policy year basis, and we are talking about underwriting profit or loss as the cost of investable funds.

Whatever its disadvantages, such an approach has three good points.

First, it is extremely simple, makes insurance comparable with other financial businesses, and will account for all of the earnings of the enterprise.

Second, it is utterly useless for rate regulation. Much of profit study has been the handmaiden of rate setting in a natural or enforced monopoly or cartel market.

Proper profits are at once easier to determine and more useful where there is only one price. Hence insurance studies borrow heavily from public utility regulation, a proud heritage unless one looks at how well the subject industry performs.

A measure as retrospective as the cost of funds approach would involve so much old data and so much projection that no one would want it for setting rates.

That is good. Just because we can do something does not mean we should. Except in automobile insurance and workers' compensation, where the utility analogy is good or becoming so, insurance prices are finally now set in the main tradition of American economic life—the free market.

The third useful feature is that it makes us acknowledge that underwriting results determine the cost of investable funds.

As in other cases where income on investment is fixed and the cost of funds is variable—as it can be for a banker who borrows short and lends long—the cost of funds can exceed the total earnings on those funds. Then the enterprise loses. Or it can pay something for the funds but not as much as they earn. Finally, in insurance as in few other parts of finance, the cost can itself be a negative number.

So viewed, an insurance company that is writing coverages which contemplate loss payments over a considerable period can only be evaluated over a considerable period. The reason, of course, is that we do not know until the end what the cost of funds has been.

To compare lines, all that is needed is a decision when to close the books. Common sense suggests it should be after the same number of years for all lines and certainly no earlier than the last loss payment in the longest tailed line.

Since we are here on a cash basis, we can skip the vagaries of reserving and proceed directly to ask why the ultimate cash cost of funds is uncertain and variable and what, if anything, can be done about it.

The first place to look is the underwriting cycle. Some of our favorite sayings about the cycle make insurance managements sound suicidal or else the prisoners of events beyond their control. Neither is strictly true.

The insurance industry is cyclical for fundamental economic reasons. The reasons have to do with how expectations about profit affect decisions about supply. When many firms share an expectation and act on it, changes in price or its equivalents follow. Since profits turn on the relation of prices and costs, a change in profit follows too.

Many industries are cyclical because of changes in demand. People suddenly do not want to buy as many cars as Detroit continues to produce. The same goes for pepper grinders and cold rolled steel.

In those industries, productive capacity has to be added in large increments or not at all. So supply remains relatively stable most of the time. Rising demand against stable supply pulls up prices and profit margins. On the way down, the opposite happens and it gets really exciting when discouraged producers and distributors unload inventory.

There are, however, some admittedly cyclical businesses in which the main cause of the cycle is changes in supply.

The classic example is agriculture. The demand for meat, grain or vegetables remains fairly constant and predictable over long periods of time. What is not predictable is how much of those commodities farmers will put in or on the ground.

The farmer has a lot of control over how much wheat or corn he will plant, and he knows his costs pretty well. But he will be selling what he raises some time in the future, and a free market gives him practically no control over what it will sell for. His predicament is making a present commitment to supply based on an anticipation of price many months in the future.

Farmers have similar information and outlooks. It should be no surprise and certainly no disgrace that they would often make similar forecasts as to price. If they do so in a free market, the eventual effect on price will be just the opposite of the forecast.

Like farmers, insurers meet a fairly constant or predictable demand for what they sell. Even more than farmers, they can vary the amount they sell rather finely and quickly. Later on they may not like what was done with prices, underwriting and so forth—any more than farmers like what happens to their prices when they all plant fencepost to fencepost. But the decision to change supply can be carried out.

In making decisions about supply, meaning sales goals, insurers like farmers tend to look at recent experience. Our elaborate techniques for extrapolation have their counterparts in the barnyard. What they have in common is an inability to call the turns.

But even where we can call the turns, the competitive market prevents the individual firm from taking appropriate action.

For the main lines of insurance and for the industry as a whole, we can call the turns in the profit cycle quite reliably two years in advance using a simple equation which compares inflation with insurance price changes, the latter being the difference between written premium growth and the growth of gross national product.

Even when warned, the individual insurer is trapped. He can only lower prices in advance if willing to smooth the cycle by giving up profits before the top. He can only raise prices in advance if willing to give up customers before the bottom. Either one is asking a lot of human nature and even of good business sense.

Both businesses can hedge the cycle. Farmers can use the futures market. Insurers can hedge by retrospective rating, by stop-loss reinsurance, by shifting investments or by executive refinement of loss reserves. But all our ways of smoothing the cycle are surely at the sacrifice of long-term total profit.

Like most of agriculture, then, most of insurance displays a supply cycle. They are both cyclical because of the basic nature of their businesses, not because of any stupidity or avarice of their managements. Those qualities can add to the thrills, but the cyclicality is there because of the fundamentals.

The analogy is not perfect, nor does it explain everything. Weather strongly affects both businesses, but in different ways. Again, the insurance supply cycle shows up not directly but in decisions about pricing, coverage and the selection of customers. Demand changes, including substitution in agriculture and new coverages in insurance, affect both industries, though not much compared with supply. Finally, only in courteous agriculture is the product of subordinate creatures referred to as fertilizer.

In most of insurance and most of agriculture the free market dominates in its textbook form—many sellers and many buyers with easy access to each other, undifferentiated products and widespread, current price information. Where that is not true—whether by product differentiation, restricted entry, neglected markets, or pervasive cartel or government control—the whole argument does not hold.

But where the cycle rules, no amount of wisdom in the individual farmer or insurer can beat it. Perhaps it is no accident that those two industries, which defer to no one in the oratory of individualism, have so often been willing to surrender so much of their liberty to government if it would only stabilize their prices.

Both the cost of funds approach to measuring return and the inevitability of underwriting cycles leads us to look at return on a very long term basis. There is one more reason—occasional mad aberrations in profitability.

Since 1910, when the data begins, only during or right after a war have insurance company returns on equity been about as low as they were in 1975 and about as high as they were last year. In each instance there was both a low and a high. It happened with every war in the period—the First and Second World Wars, Korea and the combination of Vietnam and a war in the Middle East in which our economy was part of the issue.

As for the intervals, the insurance business did well in the depression, probably because its price cartel was still working and demand held remarkably steady. It did poorly in the 1960's, probably because the stock market boosted equity so fast that premium leverage was hard to get even with the very aggressive selling which the underwriting results suggest was tried.

Last year was just another postwar peak in insurance company returns on equity. The stock market decline and underwriting losses a few years ago had reduced equity. Rate increases at the absolute bottom of the cycle then restored margins on sales and increased leverage and cash flow. Higher interest rates pushed up the yield on newly investable funds.

The free market, the arrival of new capital and, most important, the nature of the supply cycle will get those returns on equity back down before long. The peak and the trough are real enough, but neither is the stuff for wise judgments.

In summary, fluctuations in the profits of insurers, as of other businesses, follow straightforwardly from the changing relation of their costs and their prices.

The changes can be cyclical, in the natural response of a competitive market, can be secular in the structure and conduct of the business and in the occurrence and cost of the insured event, and can occasionally be in the drama of social and economic dislocations of the magnitude of war.

For all those reasons, we should evaluate insurers only over long periods of time.

For an insurance company seen as an entire financial institution, the fluctuating relation of costs and prices operates by changing the institution's cost of investable funds. We may manage by underwriting first and investing the proceeds later, but we understand the institution best by looking at it the other way around—investments at a known yield made with funds whose cost is eventually determined by underwriting and pricing decisions which are only partly free.

All those conclusions follow from quite elementary economic analysis and from the broadest of looks at the history of our business. It hardly marks the first time we have seen that the business works differently from the way we practitioners sometimes think or hope it works.

Perhaps simple understanding is enough. The ultimate goal of scientific method is hardly a canned precision or a sprawl of concepts. Not just in physics can measurement alter that which is being measured. Not just in Gothic romance are new sciences prone to create monsters.

From here on, we can be more definite only at the sacrifice of more understanding. For there is no proper profit, no perfect rate, no precise reserve, no avoiding the underwriting cycle other than by avoiding competition or the risk-bearing process itself. Insurance takes in the risks others cannot bear. It should be no embarrassment that the commerce of uncertainty is at its heart a bit uncertain.

The Nerves of Insurance Companies

This year we property and casualty insurers have lost a lot of money to nature. Once we're dry again, we'll shrug it off as what we are in business to do.

In the next few years we will lose a lot of more money to inflation, price cutting, rate suppression and too much virgin reinsurance. We'll shrug that off as destiny or someone else's lack of statesmanship.

Weather and a bad relation between costs and prices inflict big financial damage, but we can take the news in stride.

After all, we know the problems. They are within our culture and, for most of us, within our personal experience. If they are not old friends, at least they are old antagonists. We know what to do about them: be patient, reunderwrite, reprice. Be craftsmen and keep control.

But the problems nicely caught by the phrase "the riskless society" confuse us and cause anguish. Let's see what the subject really is, then why it causes anguish and, finally, whether in that anguish there may be added danger.

Now when we talk about a riskless society, we are certainly not arguing the proposition as stated.

No welfare visionary is at once so romantic and so inventive as to want a fully riskless society. No insurance baron is at once so icy and so suicidal as to want the literal opposite.

Instead, we are talking about changes in laws and public attitudes. The laws and attitudes involve spreading, through the insurance system, the real or symbolic costs of unfortunate events, sometimes after shifting those costs through the legal system. The debate is about the direction and pace of change in the laws and attitudes.

The subject so confined, the cause of the anguish becomes clear. The problem is not familiar. It does not come from within our culture. It is not curable by the application of our craft. It is not under our control.

The objective situation is bad, but we can make it worse. For a problem so distressing can easily build up psychological pressures which prevent people from intelligently protecting their own interests.

National Association of Casualty and Surety Agents and National Association of Casualty and Surety Executives: panel on "The Riskless Society" White Sulphur Springs, WV October 8, 1979

Something of the sort seems to have happened in the insurance establishment in the early days of workers' compensation and Social Security; in the aftermath of the S.E.U.A. decision; in the awakening to direct writers; in ghetto fire insurance and in medical malpractice.

In each case we either did not get what we wanted or else we did, only to discover later that what we wanted was not in our interest.

We are not alone and have nothing to be ashamed of. Every industry, government and church has at some time reacted that way to something. Our whole nation is doing it right now on energy. We are not talking about some insurance frailty but about the psychology of organizations.

We are talking about torments that can make normally sensible people so mad they lose touch with the problem. They may freeze and then fly into action, any action, just to relieve the tension. The action is unlikely to be wise. It is unlikely to balance well present relief against future costs.

Fortunately the usual day in insurance, like the usual day elsewhere, is happier and more peaceful. Those who pay and those who get paid can see their roles reversed. Policyholders and insurers have interests in common. We direct our destiny. Change is gradual and is either naturally in our favor or made so by our craft.

That is the usual situation in life, health, property and marine insurance.

Nor is it just in first-party coverages. It is true of auto liability, as long as it is seen as a transfer within the world of car owners. It is true of workers' compensation, as long as it is seen as fair maintenance of the human parts of the machine.

But in ghetto fire insurance and medical malpractice, our craft would not work. Indeed, our competence and good will were themselves at issue. We were not in control. The takers were alien and hostile—rioters, shylocks, spiteful patients and rapacious lawyers.

So beset and feeling so beset, anyone becomes fierce and vulnerable. Now what do we face today?

In automobile, the insurance has become prerequisite to owning a thing which is, in turn, prerequisite to much of our life. Yet the insurance is seen less and less as just a benign transfer within the world of car owners. The insurer could become as welcome as the collector of a bad tax.

In workers' compensation, insurers suspect that unions are urging older members to put in marginal claims, rather as supplemental retirement benefits. That

could certainly break the fifty-year truce among employers, employees and insurers in the compensation field.

In product liability, insurers see premiums always chasing, never catching, the moving laws. Manufacturers believe that making useful things is useful and that being useful does not mean being perfect. The best insurer becomes the messenger of disillusion, and hardly the maker's friend.

Our problems with automobile, compensation and product liability all have to do with changing laws and public attitudes. We cannot fix them by reunderwriting or repricing our books or by redrafting policies.

For how can the most perceptive underwriter avert an exposure which he is legislated to ignore or which only becomes an exposure after the policy is issued? Has even precognition a price if competitors, customers and regulators do not share it? Can any draftsman phrase away the threat that a stranger will someday ignore what he writes?

Our problems in those three big lines may be past our craft. The techniques of the insurance day may not be able to control them.

Then might we not react with resentment and anxiety, followed by panic to do something, anything, about the problems just to make them go away?

Yes we might. But that is danger, not fate. Many times, insurers have responded to fear with poise and foresight. The insurance institution has a larger role and more resources, and can have a larger vision, than even the best underwriter alone.

In proportion as we are bold, we do best when we anticipate and when we feel secure.

A change foreseen and handled first as an abstraction can be familiar even when unique. Change is in the world; the unexpected is in ourselves.

Not every public clamor, from cash values in life insurance a century ago to replacement values in property insurance yesterday, has proved to be against our interest. Orderly retreat—from markets, from government, from the insurance adventure itself—is hardly the best we can do.

Finally, grace under pressure is not just in the soul and the eye but in the circumstances. When the rest of our world is good, we are better able to meet unafraid a single evil.

Much of our world turns with the underwriting cycle. When feeling fine and in command, not poor and unsure, we are most likely to have the calm to master changing laws and public attitudes.

So our next test could not be timed worse. This year we have lost to familiar nature. Soon we will lose even more to a familiar excess of costs over prices.

Then, our psychic reserves depleted, we will be set upon by the unfamiliar—by strangers bringing challenges beyond our craft and our control.

As we worry about what others are crouched to do to us, we might do well to worry about what the torment could make us do to ourselves. Our difficulties are real. But the action will be in the reaction.

The Risk Money Game

Even aside from the virtues of life close to the soil, agriculture is a good model for property and casualty insurance.

Economically, they act very much alike.

Demand increases steadily. Supply varies. In a free market, prices will vary with supply.

In both insurance and farming, margins of profit follow prices which follow supplies which follow expectations of profit. Logically it is circular. Financially it is cyclical.

At most any time, insurance and agriculture will have immediate concerns, usually about the cycle of supply and profit. They deserve and get plenty of discussion.

Occasionally, insurance and agriculture undergo structural changes. Because they tend to be rare, slow and disturbing, those great changes may not get the timely discussion they deserve.

Agriculture is such a good analogy to insurance that we insurance people might learn something from the great structural change in American agriculture in our and our fathers' time—its assimilation to industry.

The science, the mechanics, the chemistry, the modes of thought and methods of organizing work which made the factory remade the farm. Our most ancient economic activity, the basis of all civilization, gave way to the culture of an economic upstart. And it happened fast, as time is reckoned in matters so fundamental.

Next door, in insurance, a parallel assimilation to other economic cultures is going on today. Much of classic, independent insurance is being taken over by the ideas and methods of merchandising and finance.

The first change was the invasion of insurance by the ideas and methods which prevail in the manufacture and marketing of standard consumer goods. It has been going on a long time and is widely recognized. We call it the direct writer revolution, a phrase which concentrates upon relations with agents. But the phrase can lead us to underestimate how fundamental and sweeping the change has been.

American Farm Bureau Federation *Phoenix, AZ* *January 8, 1980*

Wherever insurance is or can be standardized and sold to a large number of customers, the conquest of the insurance business by the ideas and methods of consumer manufacture and marketing will eventually come to pass.

It has already happened in personal automobile insurance and is well along in homeowners. Small, simple commercial insurance and individual life insurance are probably next.

Less noticed, more recent, and at the opposite end of the range of insurance complexity, the assimilation of property and casualty insurance to another powerful culture is well started. It is the assimilation of insurance to the rest of finance.

Right now you can see the development both within the insurance business and within its clientele.

Within insurance, it shows in a growing emphasis on investment income and reinsurance. The two are related, and both grow in importance as cash payments slow and interest rates rise.

Take an example. A company writes a policy for a dollar, has thirty cents of expenses and has seventy left. In the old insurance game, it would figure on paying sixty-five cents in claims and pocketing a nickel of underwriting profit along with some interest from investing the seventy cents.

Now that is one fine game to be in, but it depends on avoiding all-out price competition which, in turn, depends on either providing an insurance service of remarkable value or on having exceptionally low costs or on being part of a cartel.

In most of the insurance business today, none of those three prerequisites to old style profit is met. So we look elsewhere.

We find investment income.

Back to our example. Investing the seventy cents is worth something. The longer it is kept invested, the more it is worth. The higher the yield, the more it is worth.

In some casualty lines, the seventy cents can be kept invested for three years. At seven percent interest after taxes, it will earn nearly sixteen cents.

To the management of a typical insurer, that adds up to a lovely return on equity even without the full nickel of underwriting profit. Investment income on assets temporarily held against losses is a mighty contributor to total earnings.

So management may calculate it does not need the full nickel or even part of it. Maybe it is worth paying a little for the investment funds. After all, other financial institutions do.

When management starts thinking that way, it does not declare an intention to underwrite at a loss. Instead it goes after more premium. In most lines, the proven ways to do so are to cut prices and loosen underwriting. Management does not declare an intention to do those wicked things either. But all it has to do is press for premium when other companies are doing the same, and the pricing and underwriting will take care of themselves.

Let's see how that process might work in our example. Suppose our company cuts its price for the policy from a dollar to eighty-five cents, which can in effect be accomplished these days just by renewing at the expiring rate.

With some expenses variable and some fixed, the company might have fifty-eight cents left. Investing that sum for three years at seven percent yields thirteen cents of investment income. With claims of seventy cents, the company has an after-tax underwriting loss of six and a half cents.

Our company is still making an overall profit, but not enough to support much growth or leave much margin for error.

Now suppose the company suffers an unforeseen claim inflation of six percent a year, which can easily accompany the loosened underwriting of an insurer hard after premium. The after-tax underwriting loss nears fourteen cents. The investment income is gone and then some. Our company, wanting only to be rich, is now a loser. The sharp pencil boys must go, for the pencil sharpener has been repossessed.

Closely related to investment income is reinsurance.

There are several uses of reinsurance by a primary insurance company, such as to protect against catastrophes, to obtain a broader spread of risk, or to encourage one-stop shopping at the primary level. The investment aspect has always been there, but was the province of sophisticates in London, Zurich and Trieste, who were discreet, even mysterious.

Let's take away the mystery by putting some reinsurance into our example.

Our company wrote a policy for a dollar and had seventy cents left after expenses. Suppose it expected to pay all seventy cents as losses but only after a three year wait.

Now suppose it finds another company, the reinsurer, which will accept six-sevenths, or sixty cents, of the expected losses for a premium of only fifty-five cents. Crazy? We'll see, but let's stay with our own company a moment.

It has gross premiums of a dollar and net premiums of forty-five cents. It has expenses of thirty cents and is holding fifteen cents of premium to cover ten cents of losses.

On a dollar of business priced to give no underwriting profit at all, it now has, after taxes, nearly three cents of underwriting profit on forty-five cents of net premium. Plus the investment income on the fifteen cents it kept, or another three cents.

Our company earns, after taxes, almost fourteen percent on net sales and around thirty percent on equity, with underwriting profits significantly insulated from the cycle by the steady extra nickel it gets from the reinsurer. Not bad for not much risk.

Now the reinsurer must be a dope. Surely it will bring this shell game to a halt as soon as it catches on. Really? Let's see how the transaction looks on the reinsurer's books.

The reinsurer got fifty-five cents. In the simplest case, quota share treaty reinsurance, it has nothing much to do and incurs expenses of barely a penny. It invests the fifty-four cents for three years at the same seven percent after taxes our company does, which brings it over twelve cents. After three years it pays sixty cents to our company, which gives it an after-tax underwriting loss of just over three cents.

The reinsurer, poor soul, ends up with a sixteen percent after-tax margin on sales and, again, a likely return on equity over thirty percent. Not bad for not much work.

Note that this miracle took place on conservative assumptions and in the tamest of reinsurance markets. Note too that it started with what we traditionally call a breakeven piece of business.

Reveling in such numbers, when will either the primary company or the reinsurer stop cutting prices or making commission and other concessions in order to get premium?

Now on paper it is easy to calculate how much underwriting loss can be justified by given investment and reinsurance arrangements. But the real game is not played with such perfect knowledge and composure.

In our example, the ultimate underwriting loss, which set the cost of investable funds, was not known for three years. A lot can happen in three years. A loss reserve is not an asset. It is a hostage to fortune.

With prices driven down in the struggle for premium, and with loss costs in the future and in the mind, the game begins to take over the players.

For reinsurance, valuable as it is, does not create wealth but only rearranges it. Nor can investment income be earned on an investment account which has been spent for underwriting losses. If the original business is too severely underpriced, no investment wizardry or daisy chain of reinsurance can keep the game looking profitable unless more and more cash keeps coming in. Growth must not stop, just as there must never be final delivery of a chain letter.

Neither the investment income game nor the reinsurance game is new, but never before has either been played so boldly by so many, with such evident assumptions of perpetuity. That they may end badly does not mean they are accidents.

Instead they are symptoms, internal symptoms of the assimilation of insurance to the rest of finance.

There are also external symptoms, attitudes and actions not of the insurers but of their customers.

It began with very large corporations and very large brokers. It began with a desire on the part of corporations, quite forgiveable in light of our analysis of investment income and reinsurance, to hold onto as much as possible of the cash which had traditionally gone out as insurance premium.

The objective of corporate risk management is changing from seeing how much broad and stable insurance the corporation can buy, in the interest of budgetable costs and conserving attention for its main business, to seeing how little insurance the corporation can prudently get away with, in the interest of cutting costs and using excess capital.

To implement that one simple idea, a kaleidoscope of devices has been developed to hasten some payments and postpone others, keep money working, spread losses over time, save taxes, get at reinsurance other than through a primary company's expenses, pay for services but not for capital, contrive some nearly celestial catastrophe covers, and turn stodgy cost centers into vivacious cost centers and maybe even profit centers.

The marvel is not the intricacy of the arrangements. It is the simplicity of the animating idea—that insurance is just another kind of finance, amenable to the

techniques refined elsewhere in the broader discipline. What we traditionally call insurance is coming to be regarded as just one way of financing extrinsic risk.

If that is what is going on, the next questions are why and why now.

As to why, there are and long have been two reasons—to save money and to get risk protection not otherwise available. We may think of them, respectively, as the financial and the risk management objectives.

The essential tools, such as captive insurers and variable speed payment mechanisms, have been around for no less than a half century. The financial or cost saving motive, as with other corporate make-or-buy decisions, has been known to be around for a long time too.

What makes the present change remarkable, and entitles us to see it as an absorption of one business culture by another, is its pace, power and extent.

What was a nicety or an idea for someday or at most a glacial movement has become a rush. Why? Because of the way the second of the two reasons—risk management—has reinforced the first, or financial, one in recent years.

In the world of the great industrial corporations, efficiency (which often comes with size and capital intensity), innovation (which often comes with high technology) and growth (which is a social assumption as much as a business plan) are good, almost ultimately good. They are considered well worth taking risks for, on society's part as well as the corporation's.

In the fifty years ending, say, fifteen years ago, society's rules reflected that view pretty well, and occasional changes in the rules for shifting risks and costs were gradual and predictable enough to manage.

Then, from the standpoint of the industrial giant and its risk manager and broker, the roof fell in.

The corporation began to be held accountable for all sorts of harm to workers, consumers and bystanders which a few years before had been accepted as the price of progress. Legislatures and courts, with much public support, seemed suddenly to see high technology in terms of sinister side effects and capital intensity as inhumanity, seemed to equate size with irresponsibility and growth with dark Satanic mills—seemed, in sum, to want to force upon the corporation all of the price of progress.

Not only was this development upsetting. It promised to be very expensive.

The shift was so fast, massive and unforeseen that it could not be managed through the established insurance mechanism, a problem dramatized by the fierce market contraction of five years ago. But the great industrial corporations were not about to give up their commitment to efficiency, innovation and growth.

Around the turn of the century, another drastic shift in attitude toward the social costs of industrialization had led to the enactment of factory safety and workers' compensation laws. Then, too, the established insurance mechanism had not been able or willing to handle the change. The industrial corporations had turned to mutual casualty companies and state insurance funds—new entities but still within the insurance culture.

This time the industrial corporations, which had already started to think of risk in financial terms for financial reasons, turned outward to the larger world of finance, not its institutions but its ideas.

They found those ideas compatible with the nature of their problem. Crises of liability insurance are often in its time dimension. The ideas of finance, right down to such basic ones as interest rates and deposit balances, handle time quite comfortably.

The risk management crisis set a new pace for the growing tendency of big customers to look upon insurance as just another aspect of corporate finance. But in most subsequent conversation the first or strictly financial reason again took over. After all, why admit you did something out of fear when you can claim you did it out of greed?

The change in attitude toward insurance is important, continuing and unlikely to be reversed.

Yet insurers are hardly becoming extinct. After all, the insurance business is more sophisticated financially than it thinks it is, and there are vast markets for which neither marketing nor finance has any advantage or attraction.

Nonetheless, insurers should use the early warning of assimilation to finance to make some choices.

Some may choose to join it, in its money management and service aspects as well as in risk bearing. Others may choose to participate, but only as risk bearers. Still others may fight it on favorable terrain, by concentrating on customers which, being of moderate size or having only moderate casualty exposures, will see no benefit from the financial approach. Some may even be so expert and helpful that their customers will pay for unneeded capital to fill out the price of the service.

Those may be only a few of many sound and profitable possibilities. There are choices to be made and time enough to make them.

But using that time to advantage will require us insurers to look into the face of a structural change we wish were not there and which is gradual enough to ignore. It will require that, recognizing the change, we make choices we would just as soon put off, and then stick to them through the long night before we can see whether they have worked.

It will not be easy for us to take advantage of this time when choices are still ours to make.

Judging from the response of most of those subjected to the industrializing of agriculture and the merchandising of standard insurance, one may predict the response of most of us to the assimilation of insurance to finance.

It will be the natural, the human, response. Most of us will do nothing. Nothing, that is, except proclaim the virtues of insurance, perhaps comparing it to the family farm.

The Reluctant Growth Industry

Property and casualty insurance is a growth industry. Its sales grow faster than the general economy.

For short periods, such as last year, it may not do so because of the internal economics of the insurance business. But in the long run, insurance premiums will grow more rapidly than the total economy as measured by any of the leading economic series.

The reason is simple and important. Insurance increases with values and activity—with the economy—plus something else.

What is the something else which pushes insurance ahead of the economy's growth? Its particulars are different from time to time, but it always involves the development and spread of new coverages, the penetration of new markets.

The instrument may be an entirely new coverage. It may be a willingness to increase the supply of an existing coverage in strange contexts or at a scary pace.

Moreover, the penetration is apt to be of markets which are themselves growing faster than the economy. The fastest growing parts of the economy want more insurance, just as they want other financing, because their own capital is needed in their own businesses and because times of rapid growth are usually times of high uncertainty for the individual firm.

The extra growth for insurance is always at the frontier—a coverage or approach penetrating a market, often a fast growing market, for the first time.

After a while, the new coverage becomes so widespread, the market so saturated, that it merges into the total insurance institution. The economy or a relevant part of it then determines the growth or decline of the related insurance.

All insurance may be seen as made up of layers of what were once new offerings, almost as rings in a tree or strata in rock. The analogy is in nature where the present encloses the past, rather than in archaeology where the present buries it.

The genius of insurance as a growth industry is that it innovates to accumulate rather than to replace. Let's look at examples.

William Elliott Invitational Conference *The Pennsylvania State University* *April 25, 1980*
National Association of Insurance Brokers *Maui, HI* *May 7, 1980*

Three hundred years ago, ocean marine was the only kind of insurance. Did hull and cargo premiums track the pace of world trade? Of course not. Early on, as protection was sold for the first time, they grew faster. Only much later, with the marine market saturated, did the economic pace, specifically of world trade by sea, set the pace for insurance.

A later example is fire insurance in America in the nineteenth century. An existing coverage was extended, often for the first time, to rapidly growing property values. Premium growth was astonishing.

In our own century, workers' compensation and automobile insurance grew even faster. Why? New coverages combined with rapidly expanding insured activities.

Recently, a milder instance was the shift to personal and commercial package policies. New coverages were added as enticements or imposed as part of the replacement product. And they came at a time of rapid growth in the economy and in personal income.

Centuries of rapid premium growth, then, came from new coverages and markets or, rather, from the accumulation of them—fire insurance, workers' compensation, automobile insurance and the packaging of coverages.

Were they easy? They were not.

The accomplishments of the past only look simple from here. What they required at the time, in radical imagination and tenacity, was surely the equal of anything required of us today.

Consider fire. Since the great fire of London people had been looking for ways to control and spread costs and to finance restoration.

Only hundreds of years later did they succeed on a large scale, and look what had to happen first—the merger of fire insurance and fire fighting, analytical rating, block mapping, reinsurance, standard policy terms, monopolies, cartels and supportive government regulation.

Was workers' compensation any easier? Once finally declared constitutional here in the early years of this century, it was boycotted or sullenly overpriced by the fire insurance establishment.

Compensation only caught on after the creation of industry-oriented mutuals and the spread of loss prevention engineering and of pricing based on experience. Easily a generation passed between society's declaration of need and a confident, stable and profitable ability to meet it.

Automobile liability insurance began by being ruled illegal as against public policy—for why indemnify wrongdoers in noxious contraptions? Once inside the law, it spread with the automobile.

For social reasons a standardized or commodity coverage, automobile insurance had a natural tendency to flow to the lowest cost providers. Getting them admitted to the marketplace tore the industry apart for thirty years.

Even now, automobile insurance is racked between its original moral concepts and its modern role as a compensation system, and racked between its competitive instinct to distinguish among people and social notions of fairness more familiar in taxation.

The packaging of personal and commercial coverages also required great imagination and tenacity. Though perhaps as much a rearrangement as a fresh invention, it nonetheless roused the customary accusations of treason and madness and the effort by some segments of the business to drive others to the wall.

Innovation in either sense—coverage design or the willingness to offer coverage in circumstances which stimulate demand and frighten supply—is difficult, unpopular and hard on the nerves.

Insurance is a growth industry, but a hard growth industry.

Looking back, we see that the extra growth opportunities were not continuous, predictable and steady. They were rare, surprising and wild. It is hard to recognize one from its midst.

But we are in one now. It is called general liability insurance.

Legal change has joined with expanding expectations and economic inflation to increase the demand for liability coverage and hence the potential for premium growth. Do we insurers reach for that great opportunity? We do not. We see it instead as a problem.

Insurance is a growth industry, but a reluctant growth industry.

The liability crisis is real. So were the prologues to fire, workers' compensation and automobile insurance and to the packaging of coverages. They were not just solved as problems. For they brought our business the extra growth it would never otherwise have achieved.

At the moment, high interest rates and eager reinsurance make us feel less pain from liability insurance. But none of the difficulties which was there before has gone away.

Financial anesthetics aside, why are we so apprehensive about liability insurance? A reasonable fear of the unknown. Bad early experience trying to handle today's needs with yesterday's techniques. Anxiety about jackals with law degrees. Apprehension that every edge of change is set against us. The nature of an industry whose organizing principle—in statistics and elsewhere—is that there is safety in numbers.

Much high intelligence has been devoted to the liability problem. But it has so far achieved the best immediate results when devoted not to assuming risk, but to wholesaling and financing it for a fee or to restricting the insurance company's commitment to its client's fortunes.

Nothing wrong with that, but the big money—taking advantage of the tort expansion as another of history's great engines of insurance growth—will require something bolder. And the stakes may be higher than they appear.

Liability insurance as a missed opportunity would be a shame. Yet it would be retrievable eventually or replaceable with something else.

But the costs of missing the liability opportunity could be more than opportunity costs. The situation holds as well as the danger that our own reactions may induce behavior on the part of our customers which subtracts from what we already have.

More than ever, industrial companies are holding for themselves the portion of their casualty exposures with high frequency and low severity. They conserve what they saw five years ago to be limited and expensive external insurance resources for the less predictable and more dangerous portions.

It is a financial game, of course, but it has insurance causes and consequences. Our very averseness to risk may, ironically, be making our own books of risk-bearing business more risky.

So let us be clear that the change from problem to opportunity will have to be in liability insurance as a risk-bearing activity. Investment income and reinsurance for the sake of cash are at the heart neither of the problem nor of its solution. To be solved, while remaining in the insurance culture, the liability insurance problem must have an insurance solution.

If coping with legal liability through the private insurance business is all that important—as problem and opportunity—then how do we make it an opportunity?

Why is liability so difficult? How should we think about it? What should we do? There seem to be three aspects of the subject worth a close look.

First, because liability insurance has a time dimension, it also has a financial dimension which we can afford to ignore in the "short tailed" lines. We just have not figured out its relation to the other consequence of time delays—the exposure to adverse social, legal and economic change.

A very sophisticated question has thus been left to the analytical crudity of the politics of investment income in auto rate regulation. It has also been left to bargaining between those who live with float all the time and those who do not.

Perhaps we insurers ought to finish working out the financial dimension of liability insurance, which is easy and already being done well, and begin to balance it against the time dimension of loss exposure, which is difficult and not being done at all but which may not be impossible.

Second, liability insurance is, to a growing extent, an open commitment to stand behind the client's legal misadventures. Not that contract limits, exclusions and the like are of no effect. But with each passing year they are of less and less effect. The insurer then pays for something he did not charge for.

Apart from the problem of contract erosion, is it not the mission of liability insurance to protect the client against third parties and against the financial consequences of what he wrongfully did to them?

From our client's point of view, and perhaps our own, why all this effort to protect ourselves from him? For example, are we not on the wrong, as well as the losing, side of the argument over covering such imponderables as punitive damages?

Might we not instead become, as some insurers have in limited instances, experts on the risk aspects of the lives or businesses of our clients because we see lots of them? Then, once confident an individual client wants a loss less than we do, teach him all we can about how to reduce risk?

If all that fails, than perhaps he has earned an ally and we should defend or pay without cavil. Difference in conditions need not be only a property concept.

Third, liability insurers are at a serious disadvantage at the point of claim. Obviously the atmosphere is sour and obviously we have a deep pocket. There is more to it than that.

The underlying problem is that, at the point of claim, all parties are often trying to work with an inappropriate system for allocating money. That is not true of all tort law or all liability insurance, but it is generally true of the situations which are our worst problems now. Why?

What our society wants, it will get sooner or later from someone or other. In common law systems such as ours, the courts have, over the last seven hundred years, picked up the habit of making law—making law to vindicate the basic interests of their fellow citizens.

Legislative or private frustration of the most logical and efficient way of achieving a social objective does not make the objective go away. It just sets the courts looking for a second best way to achieve it.

Consider the frustrations of widely held social objectives which preceded the explosions in product liability, professional liability and compensable workplace injuries—the failure of regulators to regulate, the failure of unions to get better working conditions, the failure of the professions to police themselves, the failure of legislatures to make auto insurance humane and efficient, and the failure of manufacturing industry to listen and to respond other than defensively to critiques by organized consumers.

That is the short list. Even insurance may have been imperfectly responsive on occasion.

Judges, like the rest of us, saw what was, or rather was not, going on. The difference was that the judges could do something about it. After all, a judiciary that can command racial equality and legislative apportionment cannot regard changing the law of torts as much more than a day off.

As a result, we have a hodge-podge of second best solutions devised by the courts. Often they are inefficient and unpredictable. Since they often use legal liability as part of the second best solution, they often leave liability insurers with a disproportionate share of the capriciousness and expense.

Perhaps we insurers should re-examine our instinctive revulsion against legislative, judicial and regulatory efforts to limit the externalization of industrial costs and the externalization of costs of irresponsible personal and business behavior. Maybe we need to rethink which side of this whole argument we should be on.

Finally, what threw liability out of control was an unforeseen combination, and perhaps interaction, of legal, social and economic change. It was a change in the rate of change. We brought our tools of social arithmetic to a problem of social calculus.

Being human, we now tend to assume that that sort of exponential adversity will continue forever. We bring to despair the same extrapolation of the future from the recent past which we once brought to complacency.

But the law and sociology of liability have not developed at a steady pace, or in a steady direction, over long periods of time. The legal expansion might just as well slow down. The frequency and severity of the physical incidents which lead to claims might even do the same.

If the tort expansion indeed settled down, then it would again be possible to set a price for liability insurance and to hope for a stabilizing consensus on what a reasonable price should be, at least for large numbers of risks.

That is really all we want. We may never solve the liability insurance problem in the sense of making it go away and, as insurers, we surely do not want to. We have not stopped sinkings, fires, work injuries or auto accidents either. We thrive upon problems which are not quite solved.

Some of the changes discussed here could be made by the insurance business, some by society for its own purposes with insurance a beneficiary, and some might just happen. Surely they would help turn liability from a problem into an opportunity.

Seen as problems, the changes have little in common. Seen as opportunities, they have in common with each other, and with the great opportunities of the past, the demand for unconventional thinking. We should not be surprised.

For in the past, with few exceptions, the insurers borne aloft by a current growth opportunity were not those which had grown on the one before.

The marine insurers did not take over fire. The fire writers did not absorb compensation. And so on for automobile and packaging. Apparently nothing fails like success.

It is in the nature of a problem of the magnitude of liability insurance that the cognate opportunity is not clear from its midst. Yet why should we be the generation that failed, when insurance was driven into the nethers of finance or into a losing war with the society it was supposed to serve?

After all, we have the advantage of looking back at an instructive past, at the development of insurance, at the alluvial additions of coverage, at the riches hidden in puzzles, at the priceless moments for the mind to be bold.

Perhaps we will once again turn a great problem into a great opportunity. Perhaps this time, even prior success will not disqualify. Perhaps someday someone will look back with gratitude upon this chance to beat into plowshares the swords now turned against us.

Requiem for a Ratio

The combined loss and expense ratio has served in making rates for a hundred years. For a long time it has also been the test of underwriting performance.

The combined ratio is a measure. It is the key performance measure in insurance.

The combined ratio of one hundred percent is a standard. At the border between underwriting profit and loss, it separates professional success and failure.

The combined ratio, as measure and standard, is not just another number. It is an idea expressed as a number. It is an idea by which to judge human conduct. It is the insurance equivalent of Mr. Micawber's rule that happiness or misery turns upon spending six pence less or more than an income of twenty pounds.

What would happen if the combined ratio lost its moral force in the insurance culture? Could that happen? Indeed it could. It is happening right now.

The force of the combined ratio is being undermined by the shift of the mainstream of insurance from property to liability.

As a measure, the combined ratio assumes the accuracy of its components. The largest component—accrued losses not yet paid—is an estimate.

When the main line of insurance was fire, loss estimates were relatively small, accurate and short lived. With the dominance of liability insurance, they are more important, less accurate and longer lasting.

As a measure, the combined ratio is becoming less credible to those who understand how it is made. They are the people whose behavior it is supposed to govern.

The shift to liability insurance also undermines the combined ratio as a standard.

The longer life of liability reserves corresponds to longer periods of asset float. The combined ratio treats all payments as simultaneous and thus gives no value to float and the income upon it. But the value has grown too great to ignore.

Price leadership in commercial liability insurance is passing to companies which price against their total returns, just as a few decades ago price leadership in personal insurance passed to companies which priced against their lower costs.

Pricing against total returns puts all sources of income on the negotiating table. Distinctions between underwriting profit and investment income go by the board. The combined ratio, as measure and standard, goes by the board.

The combined ratio is a simple rule of conduct all can see. It will be missed. Taking down the net changes the game of tennis.

What follows the combined ratio?

There seem to be at least four possibilities. Call them chaos, perseverance, finance and bureaucracy. We will see them alone, in sequence and in combination. But none is a worthy successor.

First, we must not rule out chaos.

Take down the net. Let everyone drive on the side of the street which suits him. Revoke the Ten Commandments. The game, road or society does not get more orderly.

Shared belief in the combined ratio has lent coherence to the behavior of an industry with many participants and diverse worries and ambitions. When the center can no longer hold, things fall apart.

Yet we abhor chaos so much that it will yield to almost any alternative.

To keep order, some companies will persevere in using the combined ratio as measure and standard, just as they always have.

Sticking with the ratio confines a company to lines of insurance for which it is a good measure and underwriting profit an attainable standard. They are lines without much investment potential. They are now down to a third of total premiums and are still declining in market share.

Satisfactory growth in those lines will mean taking business from competitors, which will call for exceptional skill and market position. Almost by definition it will be rare.

A third response to the fading of the combined ratio will be like its cause—to think of insurance in more financial terms. That will mean sharing with the customer the investment income from writing his liability insurance.

An insurer may offer big customers an unbundled assortment of capital, licenses, tax advantages and labor-intensive services. The insurance company may or may not bear much risk, keep much investment income or even see much cash. In the long run, it will not control the choice.

Alternatively, a company may keep its product intact and set prices with investment income in mind. That means aiming at combined ratios over one hundred or else recalculating the ratio.

As a financial matter, various combined ratios can be set as standards for various lines of insurance. Or various amounts of investment income can be subtracted and one hundred percent kept as the standard. Either way, all it takes is a calculator and a willingness to accept less profit.

But as a rule for guiding human conduct, it is too refined to work. Various, changing, new and inscrutable target numbers will not have the moral force of a single, simple, old, familiar one. Neither will the old one with new contents.

For the end of the combined ratio is not just a financial problem. It is a management problem or, more broadly, a problem in human motivation and organizational behavior.

The fourth response is, indeed, managerial. It is to build upon the tradition of internal rules of conduct.

Insurance companies have always had plenty of internal rules and doubtless could not run without them. The rules tend to standardize behavior throughout the company. They confine the discretion which exists at all levels within it and at the myriad points of contact between the company and its clients and producers.

Of late insurance companies have been installing, often in the name of modern management, more such systems of internal rules. The move is not perverse. It is premonitory.

Organizations governed by internal rules, which are sometimes called bureaucracies, have the virtues of regularity, objective control and an ability to function regardless of the organization's external goals.

As the public demands more regularity, as managements seek better control and as the goal of underwriting profit loses force, companies will naturally rely more upon internal rules.

Not without cost. The weaknesses of bureaucracies mirror the virtues. They are dull. They resist, and are vulnerable to, new ideas. They avoid risk.

Novelty and risk disrupt the regular, predictable behavior which bureaucracies are created to achieve. Resistance to new ideas and averseness to risk are not defects of bureaucracy. They are among its essential qualities.

Insurance involves accepting risk. The insurance business has made the most profit, and suffered the worst damage, from new ideas. Bureaucracy there is not the whole answer and cannot be left to run itself. A system of internal rules cannot provide its own external goals.

If we stop with those four alternatives to the combined ratio, the prospect is for difficulty without excitement. In the heyday of the ratio, success was never so rare and failure rarely so dreary.

But there is a fifth possible response to the passing of the combined ratio.

The combined ratio is an idea expressed as a number. The idea is that insurers perform a valuable service, so that they should be paid more than they pay out and so that income on asset float is fair compensation for bearing the uncertainty of losses over time.

So seen, underwriting profit bespeaks pride and worth. If we can no longer pursue the magic number, we must pursue the magic another way.

Perhaps we will do best if we replace the ruling idea in the ratio not with other numbers but with other proud ideas which are adopted throughout the organization as business goals and as personal goals.

Those goals are apt to be of four broad kinds—to provide coverage and service at the lowest cost in competitive markets, to provide differentiated coverage and service to avoid competitive markets, to exploit imperfections in markets, and to specialize in segments of markets in ways which impede competitive pursuit.

Giving such entrepreneurial goals a chance to permeate our organizations as thoroughly as the combined ratio has done will require knowing ourselves and the world around us, setting simple business goals and sticking to them.

Cultures take time to establish and time to replace. The culture of the combined ratio is not ending all at once. It has been under pressure for fifty years. The pace of change is picking up. But we still have time.

We have time, and work enough to fill it. Doing business by ideas is to doing business by numbers as leadership is to management. Yet leading by entrepreneurial ideas is surely better than drift and chaos and better than alternatives which confine the opportunity or the profit or the spirit of the organization.

It may even produce the best underwriting results. Watching the ball puts more on the scoreboard than watching the scoreboard.

For a long time the combined ratio provided in a single number a corporate outcome, a personal standard and an organizing device. It brought us together in shared beliefs. It lighted our steps along cautious paths.

Now is an exciting time. The common lamp is going out. Now we each must find a path. Each must cross the night alone.

The Once and Future Bond

The contract surety business in the United .States did not spring fully accoutered from the brow of some financial genius of long ago. Instead, it developed quite naturally from the fundamentals of this nation — its economics, demographics, politics and geography.

Those fundamentals have changed over time and the surety business has changed with them. Today it confronts the problem and opportunity of further change. Its eventual response is less clear than is the historical record of institutions which, sustained by society's needs, failed to change as those needs changed.

Let's go back to basics and look at how contract suretyship works and at its history and then look at its present challenges and prospects.

Suretyship is an enabling activity. It enables two things to happen.

First, it tends to assure that expensive things will get done by the far-from-overcapitalized construction industry. Second, it eases entry into that industry, since a contractor with skill and confidence but not much money can get work once the owner is assured that the job will get done even if the contractor goes broke.

Hence, suretyship both encourages competition in the construction industry and improves the quality and reliability of the industry's performance.

Suretyship is an institution especially appropriate to the United States, because of the geographic size of the country, its diversity, and the magnitude and variety of its need for building and other on-site physical development.

The on-site construction industry, by its nature, has tended to favor the smaller and more local firm. There are certainly some successful, nationwide, giant firms, but there has not yet been any indication that they enjoy economies of scale or any other advantages over the smaller entrepreneurs sufficient to outweigh short lines of control and familiarity with 1ocal owners, workers and subcontractors. And suretyship has largely removed from the big firm the possible competitive advantage of great financial strength.

Yet despite its useful economic role and its satisfactory long-term, industry-wide results, corporate suretyship, especially that part related to on-site construction, has proved difficult to sustain in the world of American finance. It is a marginal activity for a lot of insurance firms and scarcely a day passes but someone is pulling out or being reorganized. Why?

The Surety Association of America, Seventy-third Annual Meeting New York, NY May 14, 1981

Perhaps it is because most substantial sureties are now parts of publicly held multi-line insurance companies, and bonding losses, when they come, are very large compared to property-casualty losses. Hence they attract attention at the highest corporate level.

That attention is rarely supportive, for several reasons.

Individual losses hit individual companies, not the whole industry and not everyone at once, and in the folklore of suretyship every loss is a mistake.

Surety losses are notoriously difficult to evaluate at the outset, and finishing the work can rival any long-tailed casualty line in uncertainty, cost and headaches. Finally, legal clouds are gathering over the surety's freedom to cut off bond credit to a sinking contractor.

Yet a large industrialized country which is constantly improving its capital base, and is doing so through a construction industry with many firms of all sizes and locations, needs suretyship or its equivalent. The geography, variety and capital appetite of the United States have so far made the surety business in pretty much its present configuration the natural answer for us.

The surety business in the United States seems, in a loose and imprecise sense, to have been through two phases and to be embarking upon a third, all related to the economic, social and demographic circumstances surrounding it.

First was the period of expanding frontiers and the initial population and industrialization and connecting up of the country. The pressure of such rapid growth meant a lot of building of a lot of kinds in a lot of places.

The need was greater than the owners could meet themselves and greater than the supply of known and assuredly solvent builders. The answer was to bring in a group of financially strong third parties to guarantee results. Whence the origin of corporate suretyship in the nineteenth century.

It may be more stylish to look for our roots in *The Merchant of Venice*, but this country was built on rational, elemental finance, hard work and good fortune, not on misplaced chivalry.

Starting some time late in the last century, the country's appetite for construction seems to have changed.

Government took responsibility for the construction of roads and schools, not to mention public buildings, and for the creation of a capital-intensive system of national defense.

Having had some rather tacky experience with negotiated or cost-plus public construction not long before, government wanted to be able to use low, public bidders. But it wanted to do so without the risk of non-performance or of cost overruns if the low bidder failed.

Simultaneously, during that second period, the industrial plant of the country was renewed to take advantage of better machinery and new sources of energy which improved the productivity of human labor.

For all those reasons, construction during the second period was rapid and varied and covered great distances, with many local contractors involved. Again sureties made sure the work got done, even if the government or corporate owner did not know the person whose hand was in the gravel or on the iron.

Right now we may be in the early stage of another, a third, period of rapid creation of physical capital, this time substituting for cheap energy and for damage to the environment which is no longer considered acceptable. One of the beneficiaries of the activity should be the surety business.

Should be, or rather can be, but may or may not be. Contract bonding in the first two periods involved guarantees of finite and usually not terribly large amounts of money over finite and not terribly long periods of time. The culture of corporate, contract suretyship — its values and its standards of acceptable risk — developed in the world of the million dollar full coverage bond for a one-year school or road job.

But are guarantees in what may be the third period of bonding growth going to be like that? Unlikely, for the most basic economic and demographic reasons. Instead, in the creation of physical capital for energy conversion and conservation and for environmental protection and repair, much of the construction industry and of the surety industry may face a crisis as great as the opportunity.

For the contractors, will the need still favor the smaller, local firms? The coming demand is not for houses and schools, but for installations of almost unimaginable size and sophistication. Can the smaller contractors learn to integrate specialties as fast as the demand is upon them? What becomes of their traditional advantages when so much of the available work is of such size and complexity?

And what of the sureties, whose own demand derives from the demand for construction, traditionally construction of a certain sort by a certain sort of builder?

Fortunately, government understands the American small business ethic and understands guarantees. Government will be in on the development in the third period because of its size and its public policy content.

In the past, government has been generous in offering the surety industry first refusal on emerging opportunities. Yet, wisely or not, our initial responses recently in perhaps analogous situations in miscellaneous bonding have been refusal — on the self-insurance of occupational disease, on nuclear disaster and on environmental impairment.

In construction too, some of the largest, most sophisticated, recent jobs have had so many cost-plus features as perhaps not to need conventional, full coverage bonds. And those jobs most assuredly did not go to firms with modest professional, mechanical or financial resources.

By conventional standards, our reasons to be wary are good reasons. The amounts are so large, the time periods so long. We are fortunate to be given first refusal, but if we refuse, the job will still get done. If performance must be guaranteed, someone will guarantee it. Our industry's reluctance to take unconventional chances will not define our society's idea of what it wants done.

The third great period of capital development follows two which not only achieved their purposes but also proved that corporate contract suretyship and small business were good partners in development. In the emerging third period, can any of us, contractors or sureties, be sure our roles and rewards will be the same as before if only we are mindful to remain as before?

The third period may indeed be an opportunity for those who build and for those who guarantee building. It may also be yet another time for an established and successful institution to benefit largely if it will only change in orderly ways some of its deepest values. The makers and builders will follow the country and someone — why not we? — will make sure it all happens as it should.

Insurance Regulation and the Unlicensed Market in the United States

In the United States, insurance is regulated by political subdivisions of the total insurance marketplace. The regulatory system is in large measure based on licensure, that is, on the governmental act of admitting insurers, one at a time, to those subdivisions of the market.

Under those circumstances, it is no surprise that the question what to do about unlicensed or non-admitted insurers is as old as insurance regulation itself. It is very much alive today in many forums.

The non-admitted market has a long history in the United States and is significant in the primary market, the subject of this paper, as well as in reinsurance.

Unlicensed carriers write some $3 billion of annual direct premiums here. American companies, often licensed only in their state of domicile, are important participants, as are Lloyd's and carriers domiciled in other countries.

So this may be an opportune time to look at the American experience with non-admitted insurers, at the origin and development of the state rules on the subject and at the prospects for both the non-admitted market and the rules governing it.

Origins of Licensure

In the early part of the past century, before there was any regulation of insurance here, several large cities (including Boston and New York) were devastated by fire. With the local concentrations of insured property values and the rudimentary reinsurance typical of that era, the fires took many insurance companies with them.

Just after the Civil War, states began to enact laws requiring licensure, after proof of satisfactory financial condition, as a condition to letting an insurance company do business within their borders. Under those laws, the customary way of doing business in a state was to have a license from the state and either an office or a managing general agent there.

The underlying idea was that requiring an insurer to obtain a license from the state, subject to yearly renewal, gave the state the opportunity to review the insurer's

financial condition and general fitness on a continuing basis. It also gave the state all the regulatory leverage implicit in the power to refuse to issue a license, to refuse to renew it or to cancel it during its term.

Throughout the history of American insurance regulation, licensure has been easy, particularly compared to the rules governing entry to other regulated businesses in this country. The legal steps are simple; no test of public necessity has to be met; existing competitors have no standing to object; and initial capital requirements are modest. Yet from the beginning insurance has also been written in every state by insurers not licensed to do business there.

The Role of Unlicensed Insurers

At the very time the licensure requirement developed, the United States was building its physical capital more rapidly than the financial capital available to insure it. Owners were often unable to buy enough insurance fully to cover their properties.

So owners had to turn elsewhere for the remainder of their insurance needs, for the “excess” or “surplus” coverage.

In those situations, licensed insurers had all of an owner’s business they could handle and yet the owner wanted more. Hence licensed insurers were unlikely to object if the owner got his additional coverage from an insurer not licensed in the state.

The owner presumably had made the arrangement with his eyes open and could hardly complain if the non-admitted insurer refused or was financially unable to pay his losses. The state was not in a position to help him, either with financial surveillance or with judicial process, but he had not made his arrangements in reliance on help from the state.

The key seems to have been that no one, such as a competitor, broker or insured, was disposed to complain or was in any equitable position to do so.

That did not remain the case for long. Shortly after the imposition of licensing requirements and the first use of unlicensed insurers to fill out capacity needs, another kind of non-admitted insurer turned up. It was the company which sold to people who were unable to get insurance at all in the voluntary, admitted market.

Upon the presentation of claims, some of those companies refused to pay, while staying safely out the state’s jurisdiction, or else turned out to be insolvent. Their behavior was early recognized as an appropriate subject of regulatory concern.

Regulation of the Non-admitted Market

By 1890, New York had a statute, which became a model for other states, setting two prerequisites for placing a risk situated in the state with an unlicensed carrier. First, the risk had to be placed by a local agent or broker who had a special surplus lines license. Second, the risk had to be incapable of placement in the admitted market, as evidenced by written rejections by licensed carriers.

In an era when the rationale for allowing the unlicensed provision of insurance was the shortage of admitted capacity, those two rules were intended to confirm that, in each case, admitted capacity was indeed not available.

Subsequently a third prerequisite developed in New York and other states: that the unlicensed carrier not have been specifically debarred by the insurance department or, alternatively, that it have been specifically approved. The rule was an attempt to keep out of the state's market, regardless of the capacity situation, insurers with bad records of behavior.

While those three requirements have been supplemented over the years, they remain the main rules for the non-admitted market.

The American regulatory system relies heavily on licensure and physical presence, for reasons of orderliness, disclosure and regulatory leverage. But it also acknowledges the desirability of making insurance available, even where the admitted market cannot or will not provide it.

The present system is a compromise. The states could have left their marketplaces wide open, as they were in the early nineteenth century. Or they could have closed them entirely to unlicensed insurers, as many have done with primary automobile insurance and workers' compensation. They did neither.

Reasons for the Regulatory Compromise

The states went to the compromise position because they were pulled in opposite directions by two powerful forces — the need for regulation based on licensure in order to protect the public and the need for outside capital to insure the developing country. If those forces were not enough to make the compromise inevitable, they were reinforced by the central role and by the needs and limitations of the fire insurance cartel.

At the time the surplus lines rules were developing, a far more serious debate was going on about the most desirable system of setting insurance prices. In that debate the alternatives were antitrust and the regulated cartel.

Different states went different ways for different lines of insurance, but the regulated cartel was the wider choice. The largest line at the time was fire, and the memory of the effect of conflagrations on insurer solvency had just been refreshed by the San Francisco earthquake and fire. Price competition was generally regarded as a drain on surplus and hence on the ability to respond to disasters and survive.

Having a single set of prices in a market requires a single effective pricing point, standardized products, market participation restricted to those who obey the rules, and effective enforcement. In insurance, that meant a rating bureau to make rates and forms, subject to state approval, controlled admission to the market, and policing of the market by both the rating bureau and the state. It meant, in short, a lot of standardization.

Role of Surplus Lines under the Cartel

After the widespread affirmations of the cartel starting about 1910, the American economy continued to outrun the accumulation of finance capital to insure it.

There still seemed no reason not to let people, who wanted more or different insurance than the admitted market offered, go to unlicensed insurers. Indeed the uniformity and rigidity of the admitted marketplace probably increased the need for a resource outside the system if the demand for insurance were to be fully met.

About that time one first encounters a new rationale for the non-admitted market besides capacity — flexibility of rates and forms. Thereafter, whenever the cartel system was strengthened, the call for free access to the more flexible surplus lines market was not far behind.

In 1944, in the *Southeastern Underwriters* case, the Supreme Court held insurance, for the first time, to be subject to the federal antitrust laws. The following year, Congress passed a law, the McCarran-Ferguson Act, granting the insurance business an antitrust exemption conditioned on its being regulated by the states.

The condition was widely interpreted as requiring “affirmative” state regulation, especially of rates and policy forms. To preserve their jurisdiction, most states enacted laws requiring prior state approval of changes in rates and forms. The effect, ironic in the aftermath of a price conspiracy case, was to put the power of the state more squarely than ever behind the cartel.

Predictably, one consequence of the *Southeastern Underwriters* episode was increased use of the surplus lines market for the capacity and flexibility unavailable in the cartelized admitted market.

The Decline of the Cartel

Starting in the 1940s the insurance marketplace began to feel the presence of companies which processed and distributed personal automobile insurance at a lower cost than the average company. A lower cost does not have to be passed along as a lower price. But the lower cost companies were relative newcomers to the market and outsiders to the cartel world and mentality, and the coverage involved was rather routine. Passing the saving along in price was only rational competitive behavior.

After years of fighting in the courts in the 1950s, the insurance departments of some large states succeeded in allowing those savings to be passed along. The attack of the direct writers on, first, the personal automobile market and, later, the entire personal lines market really began.

That development made rating bureaus less effective for price maintenance, an erosion of their cartel role continued today through enactment of open competition rating laws. The change is not yet fully accomplished, and the American insurance business has been fortunate in the gradualness of so great a change, but each year there is some movement somewhere.

Rating bureaus remain important in their statistical and actuarial role in analyzing losses and developing rates, but, except in a very few states, they no longer have a role in enforcing adherence to rates. That change has made it easier for the admitted markets to respond to the need for capacity and flexibility in coverage and price. The original reasons that gave rise to the surplus lines market are declining in importance.

A Third Rationale for the Surplus Lines

From its earliest days, the surplus lines market has also served risks which were not acceptable in the admitted market for reasons other than financial capacity or flexibility of rate and form. Today this insurance world of beauty parlors, truckers, window washers, guard services, motorcycles and demolition contractors — the specialty market — is a very important part of the world of surplus lines.

Its characteristic is not that the standard companies do not have the financial capacity or legal latitude to write the risks. It is that the standard companies do not want to write them or are not able to reach them on an economical scale.

At first the specialty market was synonymous with the non-admitted market, for only on that legal basis could an insurer charge the rates and impose the conditions which made the risks insurable at all. But as the cartel has declined and rate and form freedom has increased, it has become possible, though not yet always as

economical or convenient, to write them on an admitted as well as a non-admitted basis. More and more specialty organizations seem to be doing business both ways.

In the early days of scarce capital and rigid price control, a distinct market for extra capacity and flexibility had, almost by definition, to have a distinct legal status. That is not as true of a market which is identified by its willingness to insure. It becomes possible to push that market toward admitted status without destroying it.

The shift in rationales is one key to the market's changing fortunes. There are others, both cyclical and structural.

Cyclical Concerns about Surplus Lines

Over the years, the business and regulatory fortunes of the unlicensed or surplus lines market in the United States have varied with changes in admitted capacity.

When markets are tight, admitted insurers have all the business they want and needs are still unmet. For the last hundred years, that has been a situation in which recourse to the non-admitted market has not posed problems for admitted carriers or for regulatory officials.

When, as today, markets are competitive and carriers want all the business they can get, admitted insurers see the non-admitted competition as unfair, because it is not subject to equal legal and regulatory burdens. Regulators see it as unnecessary, because the non-admitted market is not supplying anything admitted carriers would not supply.

Those shifts in attitude have occurred repeatedly in the past.

Around the turn of the century, when markets were tight and pure capacity was the usual reason for going to the non-admitted market, the system seems to have worked without incident. That is also true of its role as a flexible supplement to the rigid fire insurance market.

In the 1920's, however, insurance markets were highly competitive and sometimes irresponsible, and state regulators and legislators called for a crackdown on "wildcat" insurance.

And so on. Most recently, the capacity crunch in the standard markets in the mid-1970's led to several years of remarkable growth and profit for the surplus lines, with scarcely a complaint from admitted carriers or regulators. Only at the end of the decade, with capacity abundant, did the non-admitted market stop growing and concerns begin to be heard from all sides.

In short, concern over the surplus lines market has been cyclical. The more willing the admitted market to provide capacity and flexibility, and to write theretofore unattractive specialty risks, the more concern about the unregulated provider. But neither the competitive nor the regulatory behavior is simply cyclical.

Structural Changes in Surplus Lines

In a competitive market like the present one, the use of the non-admitted market for capacity and flexibility becomes almost impossible to distinguish from using it for price competition and for efficient access to the fiercely competitive world reinsurance markets. To the extent it is so used, the surplus lines market is doing something which could be done as well on an admitted basis.

Similarly, the specialty market, lacking the logical necessity of separate legal status, is being assimilated to the admitted or standard market both in what it writes and in how it is organized.

More and more standard companies, seeing the superior profitability of the specialty writers, are moving into the business directly and through new affiliations. The ten largest specialty market intermediaries and managers are now affiliated with major insurance companies or brokers.

The regulatory effect of the structural changes in the market is the same as the effect of the changes in its rationale from capacity and flexibility to specialty risks. It is the same as the effect of the current competitive cycle. It is the same, for that matter, as the eventual regulatory effect of the postwar loosening of regulatory control over commercial lines rates, forms and underwriting. The effect is to push the admitted and non-admitted markets closer together.

Rapprochement of the Two Markets

The coming together of the standard and the surplus lines markets, for legal and regulatory purposes, is evident from the way public officials are treating three current issues.

First, in today's highly competitive commercial insurance markets, many people are complaining that the prerequisites for access to non-admitted markets, chiefly the requirement of prior refusal by licensed carriers, are met more in form than in substance. Some regulators have taken the position that unlicensed insurers are, therefore, unfairly free to compete for desirable business with licensed insurers which are subject to heavier regulatory obligations.

So they are trying to force through the admitted market transactions which used to go straight to the non-admitted market and to take jurisdiction of someone in every insurance chain.

The second current development is that several states have set up new facilities with some admitted, some non-admitted and some novel characteristics. New York, Illinois, Florida and Colorado have set up exchanges, free trade zones, captive havens, filing exemptions and other facilities and attractions to keep in the state and country business which would otherwise have moved into non-admitted markets here and abroad.

The new institutions symbolize the coming together of the two markets in that they occupy positions somewhere between them.

The third development is that American regulators are wrestling with the significance for public policy of the rapid growth of captive insurers and other methods of funding risk outside the established insurance mechanism. Frequently they involve unlicensed carriers.

Regulation of admitted markets in the United States is far more open, with far more scope for diversity and far more reliance on competition as an instrument of social control, than it was thirty or forty years ago. The specialty and surplus lines markets are functioning far more like the admitted market than they once did and are structurally more integrated with it.

So as the markets come together, it is easy to predict the legal basis on which they will generally do so.

More regulators more times will make more efforts to get at the non-admitted market, to make it less accessible, to hold some admitted entity responsible for the non-admitted insurance transaction and, most important, to get business into admitted markets.

Every regulator knows that an admitted market is easier to regulate than a non-admitted or a mixed one. Every regulator knows that as among states and countries, the content and quality of regulation are most uneven. He knows that he cannot always count on the insurance department of another state or another country to protect his policyholders against the depredations of an insurer domiciled there. Every regulator also knows that getting licensed by his state is pretty easy, and it is in the nature of the regulatory perspective to believe that one's own regulations are rather reasonable.

Our system is a practical compromise, quite lacking in conceptual elegance. Practical considerations now create a tendency both to liberalize admitted market

regulation for commercial lines and to bring specialty and surplus lines market activities more onto the same footing as the admitted market. Circumstances permitting, and now they do more than before, the natural regulatory direction is to close a market, any market, in order to regulate it better.

Conclusion

State regulation of insurance in the United States calls for the larger insurance marketplace to be regulated by its political subdivisions. The system is best appreciated in the historical context of a developing economy and in the legal context of a federal structure of government.

State regulation is a compromise to start with, and it contains yet other compromises. One is the status of the unlicensed or surplus lines market. It balances the desirability of closing markets by universal licensure, in the interest of orderly and evenhanded regulation, against the desirability of making insurance available, in the interest of economic development.

Originally, in the capital-starved America of the 19th century, unlicensed insurers were allowed to participate in the market because admitted carriers did not have enough financial capacity.

Later, at the peak of effectiveness of the fire insurance cartel, unlicensed insurers provided a flexibility of rate and form not permitted in the admitted market.

During those periods, the main role of regulation was to assure that the non-admitted market stayed within its rationale, that is, that it provide only coverage unobtainable in the admitted market.

With the growth of capacity and the decline of the cartel, the rationale for the surplus lines market has changed again. Its two earlier roles are less important, and less distinctive, than in the past. More and more, it is a specialty market for programs of difficult risks.

In its current role, the surplus lines market is less dependent on the legal status of being unlicensed.

Regulatory concerns about the surplus lines market have always been strongest in times of overcapacity in the admitted market, and to that extent today's concerns are cyclical and have ample precedent. But the changes today are structural as well.

The admitted and non-admitted markets are being drawn together. Their insuring appetites overlap. Their organizations are integrating with one another. Their legal positions are being assimilated to one another.

As the two markets become more alike, regulators will tend to treat them more alike. They will loosen the rules for the licensed market and will tighten the rules the unlicensed market. The distinctive legal status of being unlicensed will matter, in law and business practice, less in the future than in the past.

A Captive Insurer Looks at the American Market

Captive insurance companies are in the general property-casualty insurance marketplace in a small way. Before long they will be in it in a big way.

They will be pushed into the outside market by the need to protect the tax position of their corporate family. They will be pushed into the primary market by overcrowding in reinsurance.

They will be drawn into the market by an affirmative interest in the insurance business.

It is something they know about. It offers diversification and profit. How good it must look to any manufacturer just for what it lacks!

An insurance company does not need external capital or credit. It does not depend on the general economy. It does not have resource shortages or unions or Japanese competitors.

A captive looks at itself as a possible new participant in the property-casualty market.

The captive sees it is considering its first foray into the insurance business as an active and independent seller.

Its distinguishing characteristic is its lack of experience on the sell side of the business. It has experience on the buy side — as purchaser of fixed cost coverages and designer of risk financing alternatives. The experience is useful, but it is experience on the other side of the table.

Ignorance is not always an advantage. But the captive is free of organizational, financial, intellectual or sentimental attachments to the established way of doing things. In a changing business, that helps.

The captive can take a fresh look at the business it is about to enter. What does it see?

Four things. All can be traced to the cartel heritage of insurance, but they differ enough that it is best to take them up one at a time.

First, the captive sees that entry into the business is easy — legally, financially and organizationally.

Regulatory barriers have always been low, perhaps because when the rules developed the country was short of capital and hence of insuring capacity.

Initial capital requirements are modest. No test of public convenience and necessity has to be met. Licensure is liberal, with little parochialism.

Entry is also easy organizationally. No factory has to be built. People with necessary skills are available.

Even in the primary market, every function of an insurance company, from engineering to underwriting to investment to claims, can be purchased. The main distribution system uses independent contractors.

Entry is easy competitively. The industry is fragmented and not attuned to repelling newcomers.

The second thing the captive sees is how much insurers have to pay for the money they get to invest.

Historically, property-casualty insurance has generated investable funds at a low cost. Many companies have generated those funds at a negative cost called underwriting profit.

Recently, property-casualty insurance has generated funds at a lower cost than other financial institutions. That is one of its attractions for financially minded people.

The cost of those funds is going up. That is the main significance of the price cutting today.

Prices are always cut in the competitive or oversupply phase of the underwriting cycle. But this time the significance is not just cyclical but structural and lasting as well.

We cannot prove that proposition yet. Both cyclical and structural forces would produce the same competitive behavior right now. Proof will come if the cycle turns but prices do not go back up where they were.

Until the risk-adjusted cost of funds in property-casualty insurance approximates that in other financial endeavors, insurance will attract capital faster than customers. It will be in chronic oversupply. Insurance will be a buyer's market.

Adjusting for risk brings the captive to the third characteristic of the market it is about to enter. The traditional belief that insurance is uniquely a risk business is now open to question.

The belief is that insurance is special because the commodity in which it trades is risk. That was once true of the isolated indemnitor carrying a big fire risk on a net basis.

An insurer can still do business that way if it wants to. But it no longer has to.

Today an insurer has many ways to stabilize risk statistically, to spread it among risk bearers and over time and otherwise to conserve its capital.

The belief that insurance is uniquely a risk business confers mystique. It counsels caution. It suggests bravery. It impedes competition. It is durable.

Like other businesses, insurance involves substantial entrepreneurial risks. One of them is believing things that are no longer true.

The myth of the risk business, left over from the day of the cartel, reminds the captive to look for other such heirlooms. It finds the fourth striking characteristic of the market — the insurance numbers system.

Property-casualty insurance teems with numbers, and the business lives by them.

The annual statement filed with insurance departments contains thousands. One classification plan has a million rates. Careful companies budget the ratio of postage expense to premium.

But the captive, taking a fresh look at all those numbers, sees something about them which is usually missed. They are not of much use to an independent competitor.

Insurance numbers began with one of two purposes — solvency regulation or the development of uniform rates.

So the insurance numbers system generates rates and ratios. But rates are not prices. Expense ratios are not cost accounts. Premium writings do not measure unit volume.

Insurance data are like television news shows. They do not impart information so much as the feeling of being informed.

The captive insurer sees a market which is easy to enter, attracting new participants with cheap funds, rapidly losing its mystique and drifting in a sea of darkest data. If the captive wants to get into the game at all, it had better know very clearly what it is doing.

How should the captive proceed? What should it think about first?

It might start with where the money is made. One can think about it under four headings — premiums, losses, expenses and investment income.

As to investment income, the captive understands, having been part of the changes of the past ten years.

Insurers used to keep all the investment income on premium float. To do so today requires exceptional competitive position, an imperfect market or insignificant investment potential. Otherwise, in a buyer's market most investment income will go to the buyer, explicitly or through pricing.

As to losses, a good underwriter can select among risks or books of business. The key is to see enough aspiring customers. You can judge horses by looking at their teeth. The key is to get the horses facing toward you.

Premium growth in a buyer's market depends upon market position. It means being seen by the insured and others who control the premium dollar as a superior firm to do business with. Buying business — by raising commissions, donating facilities or extending credit — is unlikely to confer a lasting competitive advantage.

Premium growth depends on market position. Loss control depends on getting the horses facing the right way, which depends on market position. Investment income depends to a great extent on growth and loss control, which depend on market position.

So the captive thinks about market position. Two established ways of getting it are product differentiation and geography.

Some sellers are able to engineer down the cost of insuring boilers, abrasive wheels, retirement plans or construction contracts. Others are closely tied to a geographic area, its citizens and insurance agents.

A captive would not be likely to have a natural geographic niche. That may be just as well. The advantages of a close relationship with a favorable location are now widely recognized, a sure sign that geographic niches will soon come under pressure.

The position of the strong geographic specialty companies in their agencies is probably unassailable. The position of their agents in the market is the problem.

The captive might try product differentiation, perhaps by specializing in a client industry such as the industry of its parent. It is rewarding and can happen naturally in the risk management world.

Differentiation and geography can be sources of big profit, witness the California workers' compensation companies.

Yet differentiation as well as geography is constrained as to market size and as to number of sellers. A niche is a niche.

Besides differentiation and geography, one more way exists to set up a strong market position. Besides premium growth, loss control and investment income, one more way exists to make money generally. They are the same: control expenses.

If one defines overhead broadly, as the sum of underwriting expense and loss adjustment expense, then few companies have overhead below thirty percent of premiums and most have around forty.

That is not to say insurance overheads are too high, for "too high" is not an absolute but a relative concept. But they are high enough to be competitively significant. A deep and sudden cut, especially one hard to copy, would matter not just on the bottom line but in the marketplace.

The long trend in insurance has been to reduce overheads, mainly by eliminating redundant functions in the distribution system. There is still, potentially, a long way to go.

Insurance is now a buyer's market, and it is reasonable to suppose that buyers will press for lower overheads. The insurer which can attract their business can afford to take it on. Since insurance is less a risk business in the old sense, it is less capital intensive in the old sense too.

So now an insurer can turn its capital over faster and do well on thinner margins of profit. It can also turn its attention to functions directed more to its client than to itself — the control and allocation of costs and the management of information.

Provided always that it is able to get the business.

Investment income depends on premium growth and on loss and expense control. Premium growth depends on market position. Loss control depends on

market position. Market position depends on efficiency. Expense control depends on efficiency.

So apart from the niches of geography and product differentiation, all the elements of profit — growth, loss and expense control and investment income — will ultimately turn on efficiency. All roads lead to efficiency.

For a long time, that proposition has been at work in a gradual way. It is one reason for the success of the direct writers. Now it is about to go to work in a big way, and we are not just talking about squeezing a point or two out of the expense ratio.

Can captives take advantage of that situation? Four facts about captives suggest they might.

First, the experience in other industries is that during deregulation, big savings are found in unbundling services.

Insurance has been undergoing deregulation for forty years. Captives deal in unbundled services. They were among the first to see that better information technology made possible sophisticated cost accounting and loss analysis which were worth a lot.

Second, captives were created to save money, partly investment money and partly tax money, but also partly expense money.

The low expense ratios of captives are evidence the savings can be achieved. That does not prove captives can do the same in the general market. But it is encouraging. Efficiency is partly a matter of values and belief. Efficiency is a demand we make upon ourselves.

Third, likely as not the parent company of the captive is from the business culture which has been the most efficient in the past — the manufacture and marketing of tangible goods.

The most efficient insurers have gotten where they are today by applying, consciously or not, ideas from the industrial culture. It is no accident that, outside the niches, those insurers also tend to have the most formidable market positions.

Perhaps captives will be the next to borrow industrial ideas to make insurance more efficient.

Fourth, the captive has the distinguishing characteristic we started with. The captive is not part of the insurance establishment.

Call it innocence or ignorance or naiveté, but the captive insurer is not the captive of its distribution system or of its cost structure or of attitudes inherited from a seller's market.

It probably even thinks about its role differently. As a child of the risk management movement, the captive comes from thinking about insurance functions rather than insurance institutions.

Where financial functions turn on preserving capital over time and are affected with the public interest, we pass from a concern over functions to a concern over the institutions which perform them. The reason is that the institutions best preserve the capital and are most amenable to regulation.

From that develops the notion of an institutional franchise to perform the function, followed by the imposition of social and other costs as the price of the franchise.

At that point, if there is a change in what is valuable about the function, and if it becomes possible to provide what is valuable without taking on the franchise and its costs, the function gets redefined, new providers arrive and the franchise begins to look like a prison.

Captives are in the thick of just such a development in the insurance function. It is deadly serious. Ask a banker.

A captive insurer looks at the American market. It sees everyone there is a captive to something. By contrast, the captive is free.

Does that mean an awesome new competitor is about to be loosed upon the market?

No. A better question is whether the captive will do well in the general market at all.

Why? Go back again to where we started. The distinguishing characteristic of the captive is that it has no experience on the sell side of the insurance business but plenty on the buy side.

Selling is different from buying. In a buyer's market, the buyer needs to analyze and select among proposals brought to him. He needs intelligence. He does not need passion.

The great insurance success stories are about people who believed they were bringing to others something they ought to have and, often, something which had been wrongfully denied them.

The people who first wrote workers' compensation for a shunned class of manufacturers, or who first brought auto insurance to farmers at a fair price, cared deeply about what they did.

Such belief and such intense identification with their customers gave their actions a coherence not usually associated with insurance companies. They did not debate what to do each day, for they woke up every morning knowing.

Can the captive start from the reactive and cautious buy side of the business and become an effective seller?

It can be done. Many early fire and workers' compensation companies resembled association captives. Many auto insurance companies were sponsored.

But is it the same? Are roots in analytical risk management the same as roots in a product shortage?

The captive comes from the industrial and financial traditions, surely the right ones for the next decades in insurance. The captive lacks so much it is better off lacking. The captive is free.

The only question left is whether freedom is enough.

The Meaning of the Troubles at Lloyd's

Lloyd's of London is the world's largest and, to outsiders, most mysterious insurance market. In a business generally regarded as dull, Lloyd's has enjoyed a reputation for glamour (Betty Grable's legs) and daring (moon shots).

But in the last few years Lloyd's has had, though hardly enjoyed, a different kind of publicity — exposures of funds diverted, profits and losses hidden, disgrace of grand figures and public recrimination.

In most of us is a secret inclination to delight in the discomfort of the rich, powerful and glamorous. It has been a terrific story.

Insurance is at the center of commerce and economic development. Reinsurance is the way huge exposures to property or liability loss are spread across the financial resources of the world. It does not so much involve personal insurance, where individual losses are small and can be borne by a single company. It involves the multibillion-dollar energy complexes, the billions to correct environmental damage and dangerous workplaces, the yet uncounted cost of paying victims of wonder drugs gone wrong. We may call that big business insurance, but it affects all of us as businessmen and businesswomen and as individual human beings.

Insurance deals with the bad side of good things. Many of the good things of modern life require huge investments, and when they go wrong they cause huge damage. Without insurance they would not get done. Without reinsurance they would not get insured.

Lloyd's is the world's largest and most important reinsurance market. Alternatives exist and are growing, but Lloyd's is still so big and so central that what happens there is of concern not only to insurance everywhere but to economic development and commerce everywhere as well.

The public troubles of Lloyd's began when Alexander & Alexander, a large and publicly held American broker, bought a large Lloyd's broker and underwriting manager. The new American parent conducted routine audits of the Lloyd's broker after the acquisition. These revealed the diversion of funds and hiding of profits and losses which then were reported to British and American authorities and to the public.

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The great embarrassment began. It is not over but undoubtedly will forever alter one of the world's most important financial institutions. Not that Lloyd's would not have changed anyway, but the disclosures have compressed into half a decade changes which might have taken half a century. The new direction already is clear and worth understanding.

Lloyd's began as a coffeehouse. Its quaint origin is good to keep in mind. Lloyd's is a place, not an insurance company. At Lloyd's, in one vast "underwriting room," brokers carry insurance proposals ("slips") around the hundreds of cubicles ("boxes"). In each box sits an underwriter and his assistants.

On any risk of consequence or difficulty, especially when seeking the first ("lead") underwriter's participation, an experienced broker will deal face to face with an underwriter recognized as an expert in that kind of risk. If the lead underwriter accepts a portion, other underwriters will be inclined to follow.

In this respect, Lloyd's is the opposite of the typical insurance company or industrial corporation. In the room at Lloyd's, the top people deal directly with each other. Senior brokers and senior underwriters make deals person to person, one at a time. Face-to-face dealing by people of intelligence, experience and long acquaintance is a highly efficient way of conveying information.

The underwriter at Lloyd's accepts risks on behalf of syndicates of individuals ("names"). The underwriter is usually a name in the syndicates for which he underwrites, but most of the resources behind him come from others. Virtually none of the outside names watch the underwriter's work regularly. They rely on his judgment, probity and professional expertise.

For centuries, Lloyd's has been a marketplace with three participants — brokers, underwriters and names. The big transactions have been personal, and the people doing them have been very senior people deeply schooled in the traditions of the Lloyd's room.

Until quite recently, the same individual could hold all three roles and also could own part of a company which shared in the risks. Traditionally the relationship between participants was an open and informed one of trust and self-restraint. Rules were few. Crucial matters were governed by shared understanding. The people who mattered knew each other and knew how things ought to be done.

This sounds like a definition of a club. It is. Clubs are also small. Lloyd's was small. Three centuries old in 1948, Lloyd's still had only 2422 names. Participation was a privilege not widely shared and certainly not promoted. For example, only male British subjects were eligible to be names. Lloyd's was a place,

on the club model, where a small number of small businesses did very profitable business with each other. Nifty, but it couldn't last.

The economic recovery that followed World War II generated huge demands for insurance since the need for insurance closely follows economic activity, growth and the accumulation of wealth. To continue to fulfill its role as the center of world reinsurance, Lloyd's had to grow too. Premiums rose from $190 million in 1946 to $820 million in 1966 and to $5.5 billion in 1980. The number of names grew too. Eligibility was opened up in the late 1960s and early 1970s, first to foreigners, then to women. The "member's agent" took a prominent role, recruiting those who, shortly before, had pleaded to join. By 1966 there were 6062 names, and by 1982 the number had risen to 21,601.

Still the informality of the club persisted. It was assumed that everybody would understand how things were done, that everybody would make money but not overreach, that the potential for conflict of interest was obvious but limited and would not be exploited.

Growing Pains

Anyone who has managed a business with an informal, collegial style through a period of rapid growth in volume and participation does not need to be told what was around the corner. Looking back, there were premonitory signs. In the 1970s, Lloyd's was a victim of some tattered insurance scams, generally involving skimming of premium through repeated reinsurance transactions, leaving the last underwriter (in the best known case, a Lloyd's syndicate named Sasse) holding the bag of a lot of risk for a little premium.

Some of the masterminds behind the scams were Americans whose insurance licenses had been revoked long before in the more structured and governmentally regulated U.S. market. In retrospect, the message was that Lloyd's could be penetrated by unscrupulous people.

In the late 1970s, several Lloyd's syndicates collectively lost hundreds of millions of dollars by guaranteeing the residual value of mainframe computers when they came off lease. It was a silly bet against IBM's ability to obsolete its own product line. More significantly, it was a bet against one of Lloyd's few formal and long established rules — no financial guarantees. Again in retrospect, the message was that Lloyd's was not enforcing its own rules on the conduct of its own members even in the hallowed room itself.

From those two public episodes, plus others which were "contained," the Lloyd's establishment drew the accurate conclusion that the club style and mingled

roles of the old, small Lloyd's might no longer suffice. In 1980, a respected special commission issued the Fisher Report, which reached two principal conclusions.

The first conclusion was that Lloyd's needed to act more like a financial institution and less like a place which once served coffee. It led to the creation of the Council of Lloyd's, most of whose members actively or passively participate in the Lloyd's market. It was a move toward formal self-regulation. The second conclusion was that Lloyd's most obvious potential conflict, the common control of broking and underwriting, had to be solved structurally by separating the two kinds of firms. Based on the report, Parliament enacted the Lloyd's Act of 1982, putting into effect those two recommendations.

Significant Moves

The Fisher reforms, together with the quality of the people chosen to implement them, are important changes in the governance of Lloyd's and, hence, significant moves in the general world of insurance. But we should keep in mind that the Fisher Report and the events leading to it occurred before the disclosures from the Alexander & Alexander acquisition and audit.

The pre-Fisher disclosures were of abuse of common control of brokers and underwriters — an abuse of underwriters both at Lloyd's and, through reinsurance, elsewhere. The later, or post-Fisher, disclosures were of underwriters' siphoning profitable premiums out of their syndicates and into reinsurers they themselves owned — an abuse of trust and of outside investors.

It is widely expected that a forthcoming report by Lloyd's and a report to be completed this summer by the UK government Board of Trade will expose other practitioners of the lurid abuses. The Inland Revenue also is studying the tax-avoidance features of the schemes.

The lessons are clear and quite general: growth puts more stress on an organization than its insiders feel or respond to; handling other people's money imposes severer duties than handling one's own. Place temptation before a small group raised to resist it and they probably will, or at the very least they will expel from their club those who do not. Keep adding to the temptation and inviting people in and eventually some will embrace the temptation. A club rarely gets in trouble for secrecy; a public institution usually does. It pays to know which you are. These are not rules unique to Lloyd's. They are common principles of management, morals, politics, regulation and law enforcement.

Such common principles underlie what Lloyd's now is starting to do. Lloyd's has learned the hard way that it will have to become a more structured institution with more explicit rules, more disclosure and more independent regulation. It is

implementing the lessons of the first, or broker-underwriter conflict, episode by moving away from clubbiness and toward formal and explicit self-regulation. What response will follow the second, or self-dealing, episode is still to be seen.

Once the officials of the UK government and of Lloyd's take the measure of the second problem, they may decide that self-regulation can handle it. Or they may decide that a further step is necessary, some measure of direct government regulation. The American experience is that direct economic regulation is no panacea. But the experience is also that self-regulation can dwindle into a transitional stage between independence and direct government involvement.

Future Choices

Just as Lloyd's immediate problems are not painless, its long-term choices are not easy. The direction of future change is clear — more rules protecting policyholders and names, rules enforcing fiduciary and disclosure principles, and rules guaranteeing the integrity of the insurance transaction. That much is inevitable. Rules, rules, rules. Does that mean it's all over for Lloyd's? Not at all. The necessary good can be done without sacrificing that which made Lloyd's great, though the dangerous pendulum effect of Lloyd's having stayed a club too long should not be underestimated.

Strong institutions profit from their mistakes. Lloyd's was strong long before it was an institution, back when it served coffee and left the business to the customers. Now it is going through a classic middle-size crisis, remarkable mainly because it was so long in coming.

The delay is proving expensive. But if the responsible officials respond with an eye to the long-term interests of the institution and its customers, the outcome should be a more efficient and dependable marketplace.

Lloyd's old clubbiness may have permitted its greatness, but it did not cause that greatness. What made Lloyd's great was inventiveness, the spirit of risk taking, the efficiency of risk spreading from a single place and the efficiency of professionals doing difficult transactions face to face. All those good things can still be done with a rulebook in the pocket expressing what was, in a simpler time, a code of honor carried only in the heart.

Policyholders' Rights in Demutualization

In insurance, unlike most other industries, the mutual corporate form is important in competition, regulation and history. The mutual form itself, and changes from stock to mutual and from mutual to stock, long have been prominent issues of public policy in insurance. The intensity of interest varies over time. It is high now, and the reason is that corporate form is a key to two aspects of competition and even survival: access to capital and ability to adapt to the changing market for financial services.

Although the question is important to both life and property-casualty insurance companies and many issues are common to both, this article is confined to the life industry. The stakes are higher, we have less recent experience and, for historical reasons, the questions of principle are widely regarded as more difficult.

The place to start is with the reasons that we have life insurance at all. Then we can move to the reasons for the mutual form, the questions raised when a mutual company proposes to change to stock company form, and the rights of policyholders if demutualization occurs.

Life insurance long has been America's leading way of saving, investing and providing for one's children. In the nineteenth century, workers had large families, short life expectancies, almost no corporate or government benefits and few ways to save small sums of money at interest. Life insurance answered their needs. Today life insurance is thought of as protecting family values both because it does and because, in its early golden age, it did so far better than anything else.

Life insurance is thought of as a rich and staid industry, with old mutuals being the most of both and eternally consecrated to the gentle tenets of mutuality. This may be true today, but the beginnings were quite different.

The 1840s were a busy decade for the founding of life insurance companies. Yet after the New York fire of 1835 bankrupted many stock fire insurers and the panic of 1837 wiped out so much investment capital, there was not much money around for setting up insurers, and the stock company form hardly inspired investor confidence.

So practical businessmen set up mutuals, including Mutual Of New York, New York Life and Mutual Benefit Life. The idea was to have the sponsoring

insureds chip in something toward the capital, either by premiums plus capital subscription notes or by premiums alone. It was a good idea and it worked well.

However, early mutuals ran thin. New York Life started with $55,000 of capital. When Northwestern Mutual faced its first death claim, the president had to take out a personal bank loan to pay it. So the early mutual life companies were formed for two straightforward business reasons: the socioeconomic need for life insurance and the difficulty of meeting that need through the stock form of organization.

The life insurance business of the mid-nineteenth century differed from today's in two respects important to the mutual form. First, it was not capital intensive, and second, policyholders all were in the same boat.

Since the mutuals had so little capital, it was fortunate, or necessary, that life insurance did not need much capital. The main reason it did not was that front-end sales commissions were low. Mutual Benefit paid 5% of first year premium and 2.5% each year thereafter — approximately one tenth of fire insurance commissions then or life insurance commissions now.

The mutual form also was appropriate to the way companies did business then and, indeed, until well into this century. The business was individual ordinary life insurance, without group, annuities or health coverage. A company used a single mortality table, a single crediting interest rate and a single participating dividend plan. There was a community of interest among policyholders which underpinned the mutual principle.

The first steps toward life insurance's becoming the capital-intensive business we know today are traceable to a very popular product which always was controversial and now is extinct and nearly forgotten — the deferred dividend policy or semi-tontine. Under such a policy, dividends were paid only on policies in force 10 or 20 years after they were taken out. If the insured died or the policy lapsed in the meantime, little or no dividends were paid.

A Flawed Success Story

Under the accounting rules of the day, the deferred dividends did not have to be set up as a reserve liability. Instead, the premiums just added to surplus until the deferred dividends were paid. So the companies built large surplus accounts which made it possible, for the first time, to change to a sales system which motivated agents better but used up capital rapidly—the large first-year commission which was charged off when paid. When the tontine was outlawed after the Armstrong investigation, the industry was left with its capital-intensive marketing system but was deprived of the product which generated capital in its early years.

The big point about the latter nineteenth century was that life insurance was a spectacular money machine. The "Big Three" — Mutual Life, New York Life and Equitable — had more than half the market. At one point, Mutual Life was bigger than the Bank of England. Life insurance was a great American success story, but a flawed one.

As life insurers were amassing investable assets in the 1890s, American industry was being merged to soak up the excess productive capacity of the industrial revolution, capacity which no longer could be disciplined by price and production agreements after the antitrust laws. Merging up industries the size of railroading, steel and oil required huge securities underwriting power. The investment bankers did not have it, but the life insurers did.

In a management split just after the turn of the century, the Equitable Life Assurance Society (then a stock company) was the prize in a fight for control between J. P. Morgan and Kuhn, Loeb. It was the leadership of finance capitalism of the "robber baron" era in an all-out fight over a huge financial institution.

In the course of the fight, the Equitable and other companies, stock and mutual, were shown to have been guilty of all sorts of profligacy with other people's money. In the progressive era, that was enough to get a strong public response. Consequently, the New York State Legislature appointed a committee to investigate the goings-on in life insurance. The committee's chairman, Senator William Armstrong, long has been lost to history, but its energetic counsel, Charles Evans Hughes, became governor for his efforts, and nearly President.

The investigators found abuses everywhere they looked. But the main areas were excess commissions, leading to misrepresentation (mainly of expected tontine dividends); delegation of investment authority to outsiders and disregard of the interests of policyholders in governing the company. The first three areas were and are the subject of specific statutory prohibitions, limits and rules which took effect in 1907. The fourth, the interest of policyholders, was vindicated as well. For our present purposes, exactly how it was done is the key point in the Armstrong Report.

The Armstrong Report favored the mutual form and observed that insurance was "fundamentally mutual in principle," though nowhere did the report say that the policyholders of a mutual company owned the company.

In general, the report looked upon policyholders of all forms of companies as contract holders who were owed fiduciary duties by management, duties which had been flouted by managements in prior years. As to governance and treatment of others, one of the challenges to the Armstrong Committee was that it was about the first to apply strict fiduciary ideas to financial businesses. The Committee had to carry the whole load. There were no securities laws, little insurance regulation and

only rudimentary legal rules as to obligations to those who invested in, bought from, or otherwise relied upon, a business corporation.

As to how the life insurance business was conducted, the Armstrong Committee confronted the situation of all policyholders still in the same boat, where common interests easily could be identified. So it treated them alike. A policyholder was a policyholder.

The Committee's conclusions as to fiduciary duties appear today to be basic good sense. The recommendations for strict observance of policyholder rights and protection against management abuse and self-dealing appear ahead of their time. The observation as to inherent mutuality, and the bias toward the mutual form, seem correct in context.

Overall, the Armstrong Report is an outstanding proclamation for corporate participatory democracy and the fiduciary duties of management towards customers. It is not a manifesto for customer ownership. Just as the first wave of mutuals was for reasons of finance, the second, following Armstrong, was for reasons of reform.

Implications For Today

The distinction between participation and fiduciary duties on the one hand, and ownership on the other, becomes clear and meaningful when we consider Armstrong ideas in light of today's facts.

The first idea is regulation. At the time of the Armstrong Report, insurance regulation was rudimentary and largely subservient to the regulated industry. That no longer is true of state insurance regulation and, at the federal level, entire institutions to protect investors and the public have grown up.

The second idea is how business is done. At the time of Armstrong, policyholders of a given company were treated largely alike as to price, benefits, options, credited interest, actuarial assumptions of mortality and lapse, and dividends. That fact naturally led to a feeling of the inherent appropriateness of the mutual form.

But that no longer is how the life insurance business works. Now an insurer uses different actuarial assumptions for different categories of policyholders, different cost allocations, different dividends. It has many separate investment accounts for pensions, for variable life and for universal life (the last thoroughly unbundling prices and yields for the buyer to see and to choose and combine for himself). Policyholders no longer are in the same boat.

Third is the idea of contributions of policyholders. At the turn of the century, the prevailing deferred dividend policy gave policyholders an accumulation of rights which could be forfeited if they died or left. The policyholder did have some kind of right to the accumulated property of the insurance company — a right which might deserve recognition if the company changed form.

Again, the underlying business facts have changed. The semi-tontine is gone. Policyholders now receive their benefits as they go along, either in the form of annual dividends or as crediting and withdrawal rights under the new, interest-sensitive products such as variable and universal life. As a result, today's policyholder has no accumulated credit interest other than to his cash values. Since it now takes from 10 to 15 years to work off the front-end selling cost of ordinary life insurance, one could even say that in his early years the policyholder has a negative equity in the company.

Fourth is the idea of competition. The role of the life insurance business in protecting the family has changed. Certainly it no longer enjoys the hegemony over the consumer's savings dollar that it did in the Armstrong days — down from about half in 1905 to less than a third now. Institutions other than traditional insurers are offering life insurance and substitutes for life insurance. One thing is sure: more is to come. Some of the competitors are tough, impatient and well-financed.

Many people believe that the future of financial services will be in affiliation among present institutions rather than either in prohibiting affiliation or in granting radically broader powers to one or more of today's participants. The reasons essentially are historical and practical. The institutions differ so much in their public and business roles, their attitudes toward risk and leverage, their prevailing corporate cultures and their known regulatory systems.

If these differences do exist, then any corporate form that discourages affiliation on a basis which preserves the corporate integrity and resources of the affiliates will be at a disadvantage. The mutual company is clearly at such a disadvantage.

A mutual cannot be acquired. Its downstream acquisitions usually are out of accumulated profits and for cash rather than securities. Deals are done in the world of GAAP, but if a mutual buys at a premium over book, it has to exclude both the resulting goodwill and all other favorable GAAP adjustments on its statutory accounts.

Life insurance, which started with little capital thanks to the mutual form, now is fiercely capital intensive. The main reason is the high front-end commission, made possible by the dazzling but defunct semi-tontine, but there are other and newer reasons as well.

Margins are narrower, so mistakes in marketing or actuarial assumptions draw more upon capital. The investment in technology needed to support such vital new products as universal life, which invite customer transactions, is far greater than that needed for the quieter products of the past. Competing with giant institutions in the changing and unstable market for financial services requires capital that a stable and unchanging market does not. The mutual form severely limits a company's access to outside capital.

Exploring The Methods

If we assume that the sound public policy decision in favor of allowing demutualization indeed will be made, the question remains on what terms. There seem to be four general alternatives, each with its attractions and its problems.

The first method is to require the distribution of all the surplus, in cash or increased policy benefits, to current or recently past policyholders. This amounts to a liquidation of the company.

The second is to do the same thing, but in stock rather than in cash. It would conserve money but would impair future capital raising and, more dramatically, surely would invite contests for control after demutualization. The contests would be either by hostile tender or by assertion of superior rights by, say, large group policyholders. Either way, the object might be to close the company down in order to capture for the new owners the profits from a seasoned book of business once it was freed of the financial drain of new sales.

The third way to demutualize is to have a distribution or sequestration of part of the surplus, for present or eventual distribution to policyholders, on terms determined to be fair by the insurance commissioner, the legislature or the courts. The problem may be called one of thrusting onto the political process an unguided decision as to constituency entitlement. Of more practical significance, it is a problem of uncertainty and unpredictability, which are the natural enemies of business planning. Most managers would just not dare to take the chance.

The final method is to keep the surplus, represented by cash and the ability to issue undiluted shares in the whole company, in the company. The policyholders would get nothing more or less than their contract rights as holders of participating insurance policies. Does this suggest that nobody owns a mutual? Does it violate the mutual principle? Most of all, is it consistent with the interests of policyholders? These are good questions which need answers.

Two Unvarying Rules

Whatever alternative is chosen, however, two rules should remain constant. The first is that management of the mutual should have no financial interest in the conversion. They should receive no fees, no shares in any initial distribution, no piece of a takeover or liquidation. While they might, in the market or as a form of incentive compensation, acquire stock once the market independently had established a price, they should not be able to acquire stock before then. One reason the question of demutualization is so vexing is that there have been enough instances of its use for management enrichment to make us rightly wary.

The second rule is that both policyholders and the domiciliary insurance department would have to approve the change. The Armstrong principle of policyholder participation in governance of the mutual company still is valid. Insurance department approval is an obvious requirement, but deserves a caveat.

Departments are accustomed to working within vague guidelines such as public interest, fairness or the interest of claimants and policyholders. But that would be unwise here, as it would leave the departments without clear principles to apply to terribly difficult actuarial and political issues. The pure solutions — everything or nothing — would be easiest to deal with, but even they should be set out in statute or regulation in advance of an individual case.

It is clear which one of the four broad alternatives is most in the interest of the insurance company as a continuing corporate entity: the fourth. That is the one which lets the company conserve its equity and its ability to raise equity. Life insurance today, unlike life insurance at the beginning, is capital intensive. Competing in a merging financial services sector will be capital intensive.

The remaining question, however, is whether the fourth alternative is consistent with the interests of policyholders. It is widely believed not to be in the policyholders' interest, but that view may change when we look carefully at the real interests of policyholders.

Policyholder's Rights

In the normal course of events, the rights of policyholders of a mutual life insurance company are like those of policyholders of a stock company — contract rights including, in the case of participating policies, the right to whatever dividends are declared at the end of the year. But what about abnormal events? If the mutual is liquidated, perhaps its surplus goes to policyholders, although it might as well escheat to government or go to a charity designated in the corporate charter. The point is that companies just do not think about their liquidation until they have to. It is a failure, not a strategy.

Should demutualization be treated as just a form of liquidation? It would not seem so, as demutualization is a move to survive and to avoid liquidation. It will be more productive first to examine the three interests of policyholders in general: security, stability and continuity.

A policyholder's first interest is in having a secure insurance company. If you buy a policy, you want yourself or your beneficiaries to get paid. This interest is especially sensitive in life insurance, where the buyer usually will not be around to defend the interests of beneficiaries.

Second is the interest in a stable company. A policyholder wants a company which will responsibly service and renew his coverage and pay dividends upon it. We buy insurance in order to get stability and security, so the policyholder has a specific, limited interest in the continuation of the company.

Third is a general interest in the company itself. As the Armstrong Report pointed out, this interest is mostly in fair governance and treatment, for "a life insurance company, normally, is not organized for the purpose of making money for its policyholders," meaning speculative money. Liquidations are messy and expensive and tend to benefit the wrong people generally, and liquidators and lawyers in particular. In any event, this third interest surely is subordinate.

The Case Remains Open

We are free to decide whether and on what terms to permit the demutualization of life insurers. Contrary to what we may have believed over the years without close examination, the question is not closed and certainly not foreclosed by the great Armstrong constitution of the mutual principle and of life insurance regulation itself.

Policyholders must have a voice in any corporate changes of the magnitude of demutualization, and they must be treated fairly. But to give them a speculative right to consume the company in the declared cause of perpetuating it is not in the public interest.

While absolutely protecting the policyholders and the company itself against abuse by predatory managements or outsiders, we should give these venerable institutions the chance to evolve intact into a more viable modern form. The question of demutualization of life insurance companies can be expected to generate a spirited debate, for it may alert us to the nearness of great issues. It is indeed an instance of an old question — whether and how to change the legal forms of private property and economic activity when circumstances seem to call for change.

Some of our great debates have centered around that question: the argument in Roman times over separating the ownership, possession and benefits of property; the dispute over separate law for the big productive units of the Middle Ages, the manors, monasteries and guilds; in England five centuries past, the lawsuits and legislation over transferring land against the terms of an ancestor's grant; and in the 1800s, the alien idea of a corporation as a legal person created on private initiative.

Those debates demanded the best intellectual energies of their time. They hung undecided for hundreds of years. In each instance, the apparently radical change was made, and it is difficult to envision the shape of economic activity today if those changes had not been made. Our mutual life company question seems small by comparison, yet it involves hundreds of billions of dollars and touches millions of lives. And we do not have five centuries to decide this question. We may not have even 10 years.

This brings us back where we began, with a question of adaptation and access to capital. It is a question whether those sound business objectives can be achieved consistently with sound public policy and respect for our heritage.

However modest our present question in the scale of history, it still is urgent. The decisions about financial services in America are being made right now and all around us. They are not being made in an orderly way, but they are being made, and they will stick if the public takes what these decisions have to offer.

With mutual life companies, we in business and regulation have a chance to make one of those decisions rationally; we just have to think clearly and fast. The alternative is not that the decisions will not be made, but that decisions will be made by default or by someone else, and time will pass us by.

Life insurance is an important American institution. Mutual companies are half of it, and if they are to continue their role, mutuals must adapt to what the American family needs. Perhaps they will adapt and perhaps they will not, but we ought to give them the chance — there is no historical or public policy reason not to do so.

The Eighth Cycle

Two years ago, insurance prices were in a free fall. Buyers were in the saddle. The economics of the insurance industry were at work without pity, wringing out excess capacity — financial and human.

Today commercial and industrial buyers are scratching for coverage. Towering price increases may not be enough. Insurers see ahead the returns on equity of seven years ago. Investment bankers rush to attract more capital for them to earn upon.

A curiosity of this tight market is that many people see it as an opportunity. They will return to most parts of insurance once prices seem right.

Before long, in much of insurance, price competition will resume. Too much financial and organizational capacity is still there. Much wringing out remains to be done.

But that is not true of all parts of the insurance business. In some, the withdrawal of capacity has been impelled not by price but by fear, not by knowledge that prices are too low but by ignorance of what prices should be. There the shortage of capacity should last long enough to render academic the question whether it is literally permanent.

Those areas include high excess general liability, professional liability and financial fidelity. Large amounts of those insurances are essential for manufacturers, professionals and financial institutions to function. Their functioning is, in turn, essential to our economy and society.

Private insurance is more important in America than in any other country. Normally its role is to enable other things to happen freely. Right now, it threatens more to prevent than to enable.

That is not to say insurers are behaving unreasonably or are pursuing some silly doctrine. But it is to say that this is not just a routine turn in the underwriting cycle. It has structural as well as cyclical causes. It will have structural effects. Insurers are behaving according to their nature, often a more radical force than doctrine.

Precedents exist for situations like this, and their resolutions have a pattern. It is happening for the eighth time in this century.

Commentary (Marsh & McLennan) *December, 1985*

First, around 1900, big city fires repeatedly bankrupted many insurance companies. With companies gone, rates went up and profits improved. Insurers came back. Before long, price cutting resumed.

After enough of those gyrations, the makers of business and public policy concluded that the way to deal with recurring fire insurer insolvencies was to prevent them. That meant building surplus. It meant holding rates up in the good times to provide for the bad.

Simple price maintenance had been tried before but could not survive profitability. At the turn of the century, industry and government leaders decided that far more pervasive cooperation was needed — on rates, forms, commissions, statistics and fire fighting itself.

Thus, the 19th-century insolvency crises led to the establishment of the fire insurance cartel. It was a surprising departure from prevailing norms, coming at the height of general antitrust fervor. It was also of lasting importance. The creation, reign and decline of the cartel are the most significant events in the history of the American insurance business.

Second, around 1910, states required employers to pay injured workers. Manufacturers had to have workers' compensation insurance. The established fire and marine insurers would not sell such strange coverage or else would sell it only at prices which the manufacturers considered exorbitant.

Much of the need was met through the creation by those manufacturers of new, mutual insurance companies to write workers' compensation. The mutual liability insurance business was born.

Third, in the depression of the early 1930's, mortgage guarantee insurers went insolvent. That led to the bankruptcy of mortgage lenders and the loss of their depositors' money. States outlawed mortgage guarantee insurance.

Demand for home mortgage credit boomed after World War II. Returning servicemen with new families could not meet conventional credit standards. Without insurance, no loans. Without loans, no homes. Without homes, no suburbs.

Postwar America was urgently committed to the family in the house in the suburb. Its government did not pause to make private mortgage insurance legal again. Government just replaced it.

Fourth, after the war the boys laid down their rifles, picked up their cars and resumed killing people.

Auto insurance claim frequency went up. Loss reserves were left behind by the postwar inflation. The statute expired which had suspended the right to sue servicemen. Auto insurers faced heavy losses.

But postwar America was dedicated not just to the families in the suburbs but to the cars connecting them to work and leisure. Insurance let the cars move. Who dared cut if off?.

The dominant companies, with independent multi-company agents at arm's length, could and did. The direct writers could not. They had exclusive distribution systems to which they owed their very existence. They were not strong at the time. Their market shares were small. But they stayed in the market. They felt they had to. They never left.

Fifth, during the Korean war, the economy heated up. Consumer prices inflated. Factories were working at capacity. Workers got hurt. Workers' compensation loss frequency and severity went up. Reserves were inadequate. Established underwriters cut back. But there was a war on and manufacturers had to have coverage.

The result was the rise of regional workers' compensation specialists. They grew up where the guns were made. Competitive protection helped. In the arsenal state of California, they came forward just in time for a phenomenal surge in the regional economy.

Sixth, until the late 1960's, property reinsurance was largely controlled by brokers in London who arranged and allocated world capacity. After Hurricane Betsy, London cut back.

Concentrations of industrial property, built up in the postwar boom, were the heart of our economy. They needed big property insurance. Primary insurers needed big catastrophe reinsurance.

The reinsurance tail of the hurricane led primary insurers to create world reinsurance networks directly accessible to them. Lloyd's share of the reinsurance market began a decline which continues to this day.

The seventh market turn — the last before the current one — was in liability insurance ten years ago. In the inflation following the oil shock, loss reserves proved inadequate.

Changes in tort law rules and other kinds of social inflation added to insurers' worry and resentment. But economic inflation did the real damage on the liability side of insurer balance sheets. On the asset side, a stock portfolio crisis just made it worse. Panic was the rational response.

Insurers cut back on liability coverage. But corporations had to have it. Basic amounts were required by law, others by prudence. The response by corporate customers was the risk management movement—financing small losses, unbundling insurance services and pushing commercial insurers up to high levels. Brokers changed from salesmen for insurance companies to professional advisors for clients.

Now we are in another sharp turn in insurance availability and pricing. While at the moment it seems across the board, it is most powerful in the high excess and exotic kinds of liability insurance and in financial fidelity.

Whereas economic inflation drove the casualty insurance crisis of the mid-seventies, the current one is driven by terrible events and by changes in liability law, coming after a protracted insurance price war partly caused by the dissolution of the fire insurance cartel.

After such product crises as asbestos, after such professional crises as medical malpractice and after the weekly thrills in high finance, it is no wonder that insurers fear the unknown and pull back from it.

The crises run across whole industries and the wide distribution of products. Insurance has met liability problems before. These are liability disasters. No exclusion is reliable, no excess level out of reach. Covers pay rarely but they pay big.

A couple of years ago, with few losses, insurers felt safe. They could drive rates as low as they wanted without contradiction. Now the same covers and levels have been hit and hit hard. The same lack of statistics means that no rate can be proven too high. Ignorance and fear, the horsemen of insurance panics, run wild.

Most frightening is the insurance of economic activities in which someone says “trust me” to someone else. Whoever makes pills, emits fumes, gives opinions or takes deposits is saying “trust me” to someone or everyone. When those activities go wrong, the law now calls for recompense and more, without regard for diligence or extenuation.

At this early stage, insurers do not welcome the enlargement of their role in the general liability payments mechanism. The reason is they never took in the premiums.

Perhaps one day they will welcome it, because being assigned a larger role is how the insurance industry has grown in the past. But that is for later. Right now, they just cut off coverage.

Liability law and insurance do more than spread risk. Through premiums they bring back to activities, visibly and in advance, costs of those activities which might otherwise be shifted silently to society as a whole.

Hence the availability, security and price of liability insurance can deter certain kinds of conduct. How serious that is depends on the importance of the conduct and the strength of the deterrent. If they are important and strong enough, insurance itself changes. Existing insurers may not give in and, individually, they may be right. But from a larger and longer perspective, insurance changes.

In seven previous episodes, when established insurers could not or would not meet an essential demand, the demand was met some other way. Usually it was met by a new institution. The moral of the seven stories is that really serious insurance needs do not go unmet.

It was true of solvent fire insurers, which let us build cities and live together. It was true of workers' compensation, which made the workplace more humane. It was true of mortgage guarantees and personal automobile insurance, which rewarded veterans with families in green suburbs. It was true of the property insurance which let us amass great industries.

Let no one imagine that the denial of insurance could have stopped economic and social movements of such power.

The same will prove true for excess and professional liability insurance and fidelity bonds, alone or along with the underlying laws. They are at the fine edges of science, production and finance. The question is not whether it will be done but by whom, on what terms and at what cost to the established insurance business.

If we accept that the insurance need will be met, there are three kinds of people to meet it. First, the leaders of the insurance business. Second, customers banding together. Third, a new participant. Let's take them one at a time.

Looking back, we see that the established insurance business has responded well to many past crises. Those crises have been amenable to price increases and rationing of supply.

Where price and routine supply are the problem, they are the solution. The insurance industry solves such problems both because it can and because the insurance business is there. It has first look and, after all, insurers are in business to insure.

Government is usually part of that response. Regulation is a reactive activity. The existing business is what it reacts to.

Both business and government have techniques for dealing with the noisiest crises of today. Taverns, day care centers and even municipalities can be handled with such familiar tools as surplus lines, market assistance plans, underwriting associations or just letting the market calm down and get prices in line with costs.

But the big economic and social problems we are concerned with here are not like those of bars or bad drivers. Settled insurance companies and their regulators are unlikely to solve those big problems. Not that they do not want to. They do not know how.

If there are three possible rescuers — establishment, customers and newcomers — what about the second?

Customers uniting are the great success story of the insurance business. Many famous names began that way. Insurance has been a wonderful business for the little guy, particularly if he started by wanting to buy some and found that in order to buy some he had to sell some.

The customers did it again in the risk management movement. They created about twenty percent of the commercial insurance business out of whole cloth or, rather, out of the overhead costs, the fears and the financial attitudes of the established insurance business.

Can the customers once again solve their problem? Is it like the imposition of new compensation law or an unjustified panic among the insurance establishment? What is the problem we are setting out to solve?

The problem is that new physical, social and legal standards are being imposed on people who hold themselves out as special. That goes for advisors and for the makers of pills. "Trust me" is being taken seriously and called upon aggressively and for unimagined amounts of money.

That is not good news for customer cooperatives, at least as we now know them. At the high liability levels where we are suffering today, customer cooperatives have a lot of the same problems as conventional companies. Captives may do better at new latitudes than at new altitudes.

For the conventional captive, predictability, service and routine finance were the idea ten years ago. They are not the idea now. Ten years ago, excess and reinsurance readily supported risk management. Today their absence is the problem. Now we need capitalists, perhaps from among customers, but capitalists nonetheless.

Most likely, therefore, is the third possibility — that our present problem will be met by a newcomer barging in and rewriting the rules of the game. It may look like an association captive daring new heights. It may be a fund to compensate without fault, but as an exclusive remedy, those inevitably injured by, say, an approved new drug. It may look entirely new.

Whatever its form and however great or small its novelty, the next solution will for the eighth time in this century certainly display one characteristic — the determination to make coverage happen. Coverage always happens. Insurance needs as essential as ours today always get met.

Most likely the answer will be, in a sense, like the others. Someone will meet the need because he has to. His clients will come easily because they need him. Potential competitors will not believe his success because few statistics mean low credibility. They will sincerely declare he is doing it with madness or mirrors during the few precious years he needs to get entrenched.

Through this simple process, he will get rich. So it has worked seven times before.

Seven cycles have changed insurance. Each was born of fear and need and a lack of alternatives.

Just now it may be good for practical people to know what is to be read and seen in the past. For every condition is present again. Perhaps the eighth cycle is at hand.

After The Price War

Price wars end, but not in armistice. We do not withdraw from battle. We flee, often heedless of what we leave behind.

Insurance has just come through its first price war fought outside the restraints of rate conformity and regulatory delay, without rules on proper combatants and weapons. It was a war without uniforms.

It was the first price war fought in commercial liability, where uncertainty over costs can be long, and the difference between rates and prices can be wide. Much of what went on was out of sight and its reckoning only later. It was a war by twilight.

The war ended in shock, as they do. It ended with jumps in price and cuts in coverage. It ended with a raveling of ties of cooperation and civility.

As we pick over the field, what is gone that was familiar; what is new that may remain?

What may have been lost are arrangements for an industry of thousands of participants to function as a single system, with steady internal and external relations.

In a price war, most insurers cannot control their own behavior. They are defensive, not predatory. But on the way up, they can control what they do. Just as insurers thought they were giving too much yesterday, customers believe they are taking too much today.

Historically and at best, relations with customers are patient and trusting. Now they grow brittle and wary. Relations among insurers and between insurers and reinsurers permit diffusion of risk throughout the system. Now they permit arbitration.

But if insurance ever ceased to be a special industry based on regular relationships, what would come next? Four possible developments can be seen or suspected, and would make sense in light of what is being lost.

First, self-help. Congress has broadened the ability of business corporations to retain risk against their common capital, gaining advantages of insurance without going through the insurance business.

Customers with unmet needs have contributed equity to provide themselves with excess liability insurance at capital-intensive levels. Insurance brokers are merchant banking this attack on a shortage of capacity.

Ideas that can get into a federal statute or a corporate capital budget have perseverance. They probably have endurance as well. Both came from frustrated buyers. Unlike changes in price, underwriting and coverage, the new arrangements are beyond the reach of insurers.

Second, reinsurance. Traditionally, reinsurance increased capacity and disciplined primary prices. Now it seems to do neither. Keeping big net lines is a temporary necessity. The practice could continue, with less reliance on reinsurance relationships.

Statutory accounting blurs the economic reality of liability insurance. Big reinsurance transactions have been used to bridge the economic and accounting worlds and to pilot out of liability disasters. The transactions got a bad name, partly due to confusion between shifting risk and discounting reserves.

Reinsurance is too important to decline as both a relationship and a transaction. The likely trend, parallel to the rest of finance, would be for reinsurance to become more a trading market, at longer arms' length, with more bought deals.

Third, uncoordinated coverage. Traditionally, insurance policies have been standard in their main provisions. That arrangement made possible the building up of excess cover and the reinsurance of large risks. It let insurance work as a single system without forcing a smaller number of participants.

Now we find a variety of claims-made, indemnity and excess liability forms. To the extent the variety is respected by courts, the ability of the insurance business to face the buying and claiming world as a single system will have ended.

One reaction could be for the business to divide into a few huge insuring alliances, each having its own forms and its own leaders, followers, excess writers, reinsurers and retrocessionaires. The demand for congruent coverage may be strong enough to reshape the industry to provide it.

Fourth, regulation. Government has a role in insurance and has constituents on both the buy and sell sides. At most times it has had power over solvency, prices and products, and intermittently over availability as well.

During the past twenty years, government has reduced its influence over prices on the premise that markets work. It has increased its influence over availability, though always in areas of specific social importance beyond insurance — transport, worker safety, race relations.

The price war and its violent turn have brought government back into pricing and onward into a generalized concern with availability. Government might even join business in grim resolve that what has just happened must never happen again.

The four developments have in common that everyone is looking out for himself in a less friendly and cooperative world. If relationships were casualties of the price war, then the field is being occupied by people who do not need them or who bring their own.

Self-help arrangements are attempts by former buyers of excess liability insurance to meet their own needs. If reinsurance declines as an economic relationship, it will grow as a financial transaction. Master syndicates or merged companies would organize capacity other than through integration of standard forms. Government direction of price and supply would mean quitting the market experiment in search of a new or very old stability.

The four may not happen. They may not work. They may not last. But they are telling us something important, something about relationships and trust and working together, with our customers and with each other. They are saying the old way is a good and pleasant way of getting the job done, but it is not the only way and it is in jeopardy.

Usually changes in insurance come when an essential need is unmet because insurers withhold what is needed. It happened in workers' compensation before the First World War, in personal auto after the Second, and in commercial liability ten years ago and again last year. Sometimes a new competitor comes in, and sometimes insurers just come back.

Where the displacement of existing insurance is most likely to be serious and permanent is where the earlier crisis led to change in the structure and rules of the marketplace, to placing the big decisions out of reach of insurers. Many years later, the structure and rules can prevent insurers from responding to a need unforeseen before. Something the industry would not do is transformed into something it cannot do.

There is one big precedent — the events leading to the nationwide marine definition.

In the nineteenth century, insurance meant fire and, far smaller, ocean marine. Fire insurance had a history of price wars. Companies would cut prices, only, to go broke in a city fire. Around the turn of the century, the industry and those who dealt with it concluded that bankrupt insurance companies were a menace. Fear more than avarice bore the fire insurance cartel.

Fire insurance was controlled by agreement on rates, commissions, territories and policy terms — agreements among local agents, companies and state regulators. For the first years of the century, it worked well.

At the same time, American business was organizing itself along quite different lines. The local plant and family store gave way to the giant manufacturer and chain retailer with many factories and stores and with moving, fluctuating inventories.

The local, standard, rigid fire insurance business could not respond to the most dynamic segment of the American economy. Some leaders in fire insurance saw the opportunity. They tried to provide multi-location coverage with adjustable values. But the restrictions laid down by their predecessors proved too strong.

The needs were met by ocean marine insurers here and at Lloyd's. They were unregulated as to rate, form and location. They were used to all-risk coverage, fluctuating values and property on the move. They were oriented toward brokers in financial centers rather than agents in towns. They took the new business as inland marine. Fire insurance premiums stayed flat during the mid-1920s. Lloyd's marine premiums went up sharply. Domestic marine premiums went up two and a half times.

Eventually the border war between fire and marine insurers was settled by the nationwide marine definition of 1933. It delimited the powers of marine insurers, but not before the commercial property business had recognized new participants, broad policies and the new needs of its customers. Multiple line underwriting, the package policy and probably the end of the fire cartel itself became just matters of time.

The inland marine story teaches that after a hundred years of price wars and catastrophes, the fire insurance industry was able to encircle itself with restrictions that restrained it from responding, decades later, to a new and unforeseen opportunity.

It is no accident that price wars seem to be the one form of misfortune that can impel the insurance industry to create, or at least to tolerate, lasting structural restrictions upon itself.

Price wars are the least pleasant form of competition. They have no graceful ending. They breed guilt, rage and helplessness. They turn friend against friend. They are civil war.

Today's deterioration in insurance relationships — with customers, other insurers, reinsurers and regulators — was brought on by a price war.

Competition, including price competition, is part of an insurance world in the making for fifty years. We want it whether we enjoy it or not, and we have it whether we want it or not. The open question is its cost, to society and to us.

Part of that question is whether the price war and its aftermath are leading us to abandon relationships which have enabled us to respond to opportunities in the past and to let their place be taken by people and practices and rules which will prevent us from responding in the future.

The price war is over. We were right about its power to destroy. Today is our victory. Yet we would do well to celebrate insurance as well as insurance profit, for the relationships which in victory we might cast away are for all of us the best ally in every war.

Remembering A Stable Future

Insurance has many natural qualities that favor a price competitive market. It is an easy business to enter; supply and demand tend to grow; the product tends to be standard; and the small player can do as well as the large.

Those same qualities tend to let competition go too far for most people's comfort before it turns, all the more so since sellers do not know many of their costs when they decide their prices. Excess in competing prices down leads to excess in pushing them up. Hope and fear are not the stuff of exact science.

All that would not matter if insurance were small and trivial. But it is large and vital. By making losses fall lightly upon the many rather than heavily upon the few, it stabilizes costs and lets useful but risky activities go on.

So when prices change sharply, it is natural for the business, its customers and government to try to hold back the change. They want the stabilizer to be more stable itself.

There are three ways to make a business stable in price: monopoly, agreement and regulation. We have tried them all. Workers' compensation funds and Social Security are monopolies. The rating boards and bureaus of the first half of this century were the centers of price agreement. Official promulgation or prior approval of rates make government regulators the enforcers of stability.

Over the years each of those three approaches has worked in its time but not beyond its time. The reason always has been the changing structure and enduring natural economics of the insurance business. Recently, here as in other industries, we have come to court the inevitable and let the competitive market function and largely balance and correct itself. That is certainly the best system for today and for the foreseeable future.

But it does not make any of us happy all the time, and never makes all of us happy at once. What we really want are the benefits of competition together with the stability of suppressing competition. Anyone who has used a telephone or ridden an airline recently can sympathize.

This attitude toward having and eating cakes is neither stylishly current nor uniquely regulatory and is certainly not peculiar to insurance. It just happens that after a price war and sharp correction in our industry, the initiative is naturally with customers and regulators, though plenty of underwriters and producers would like to be protected too.

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Today's way of suppressing competition is a modified prior approval called band or flex rating. The idea is to permit price variation within limits without government approval, but beyond those limits only with approval. It is supposed to work on the way down as well as on the way up.

It is a well meant idea and plausible on its face. We do not need to get to whether it is a good idea, assuming it could work, because it cannot work. The cost in suppressing competition would be much higher than widely supposed, and even so the benefits would not arrive. It is important for all of us — in the insurance buying and selling world and in government — to understand why.

First, the main reason band or flex rating would not bring price stability is that the modern commercial insurance industry has too many pricing points ever to control. Rates, both as sent around within an insurance company and as filed with any public or private agency, are far from the same as real market prices.

That assertion does not mean people cheat, or at least not that they have to. It just means that coverages, deductibles, experience adjustments, dividends, debits, credits, underwriting standards, terms, endorsements, financing arrangements and the like are complex. They vary from risk to risk.

They are largely decided in the field and jointly by the broker and underwriter.

Insurance is always in tension between charging everyone the same and charging each according to his likelihood to have a loss. In the last forty years we have come a long way toward having insurance reflect the insured's chance of loss and his ability to bear it.

During the last price war, insurance company managements learned that they could not control their own prices with any precision. It was as true of small commercial business as of large. If management cannot control its own prices, then we ought to be able to learn by logic rather than only by experience that no outside agency possibly can.

The last chance for band or flex rating, or for meaningful prior approval of any kind, was about forty years ago. Rates in the book were closer to prices in the market. Variations were limited. The business was dominated by local independent agents. Rating bureaus could compel conformity. Government, state and federal, talked a good game about competition but was basically against it. The places where prices were decided — the real pricing points in the market — were few, central and identifiable enough to get hold of.

None of that is true today, and we could not restore it even if we wanted to. Band or flex rating lives in nostalgia even more than in hope.

But that does not mean we might not try, which brings us to the second thought — the cost of suppressing competition. The only chance for price regulation to work is to kill price competition first, just in order to have something to regulate. Usually we think of lack of competition as a result of regulation, but at least in insurance it is really a precondition. We do not kill cattle by eating them. We kill them first, in order that later we may have beef.

Imagine what the effort would involve! No debits or credits, no discretion in the field, no surplus lines market, no risk management, and standard prices, commissions, deductibles and so forth.

Perhaps worst, the least flexibility of price would be in special lines, places and classes with the worst cost problems, for statistics are least credible in small universes. In just those areas, a price problem translates most quickly into an availability problem.

The list of market prohibitions would constantly expand, for we are talking about reestablishing a cartel. People exercise creativity around the edges of cartels, and the accepted way to pull them back into line is to extend the cartel's reach and power.

Even so, it might seem that flex rating could work in small commercial lines of insurance. Maybe the method would just be to assimilate them to personal lines, which is happening already. Maybe the method would be to press them into broad classes and then class underwrite and class rate them as we did forty years ago — either way to make the coverages back into commodities under cartel control, public and private.

Since small commercial lines are where the reaction of customers to price rises has been political rather than financial, it would also seem to answer an immediate clamor to do something.

Hence it is especially important to see why flex rating will not work even there.

Class rating did work when small commercial insurance was mainly fire insurance, with physical assessment of risks and fast feedback of results. Now the small commercial insurance which concerns us is liability insurance, with neither of those necessary qualities.

Even when small commercial insurance was fire, class rating lost its ability to stabilize prices under competitive pressure to divide and subdivide the classes. With more liability exposure and more competition now, it would not have a chance.

The cost of a doomed effort to go back would be to deprive small business of most of the advances in competition and sophistication made in commercial insurance during the last forty years. Perhaps those consumers will accept the bargain, but they should understand it for what it is.

The alternatives to such efforts to recreate the past are so unreal as to require only mention. One would be market surveillance pervasive enough to track all the field variations of today and to determine whether each was inside or outside the permitted band. It would collapse administratively. Another would be filing plus an undertaking not to vary beyond a certain amount. It would collapse, if not morally then under market pressure.

The inevitably unsuccessful experiment with band or flex rating would have one last, rather sad, cost.

It would come at a time when prices are leveling off and starting to decline, because prices do rather quickly reflect costs in a competitive insurance market. That would really mean the effort to kill competition was unnecessary. But it might be taken as evidence it was working. If so, the episode could beguile us to the thought of going back into an imaginary insurance world, where everybody won the benefits of competition and nobody paid for the prize.

We may all be forgiven a yearning for the past and for a selective remembrance of stability in it. Flex rating is not a middle ground between open competition and prior approval, because there can be no middle ground. It is a choice, and history has made it for us.

The structure of the insurance market, the needs of customers and the limits of government power have put us in a competitive industry. We will end up there, however much we pay for detours of hope that we, uniquely we, ever can go home again.

Choices in Regulation

The regulation of property-casualty insurance, like the regulation of other industries affected with the public interest, is mainly reactive. The regulators may from time to time initiate programs, but usually, even in the programs, they are responding to something happening in the regulated industry. That is not bad; it is just a fact.

What insurance regulation is reacting to now is competition — within the business, from outside providers and from traditional customers. The state commissioners may see it as a jurisdictional tussle with the federal government, but it is less that than an open question as to how regulation, any jurisdiction's regulation, will deal with competition.

We can break down the competition question into three regulatory questions. First, do we as a society want price competition in insurance? Second, are we able to deal with problems of the casualty business that dominates insurance and the competition within it? Third, can regulation handle the challenges for solvency regulation that follow from competition and casualty dominance?

As to federal regulation rather than state, replacement of state by federal regulation is rather remote unless the states mess things up entirely, which is also rather remote. The serious, practical choices for both state and federal students of the business have to do with competition, casualty and solvency. On that, times have changed a lot in the last 15 years.

On competition, generally, the die is cast. In personal insurance, leadership is with the low-cost providers. That will surely stabilize competitive swings. Personal insurance is now more sophisticated than commercial when it comes to efficient delivery and service, but that has not always been so and need not be so always.

In commercial lines, competition, efficiency and dependability are the objects of all the innovation in risk management, financing and the unbundling of services during the past 15 years. A squeeze on overheads follows here as anywhere price mysteries dissolve. A few decades of turmoil are ahead in commercial lines on the way to the certain destination.

Regulation is often driven by personal insurance changes, but let's consider how it is apt to react to changes in the commercial and industrial market.

One thing is for sure: Regulation will go more and more to protecting insurer solvency and to minimizing the effects of insolvency. Yesterday, the greatest

regulatory states had the smallest insolvencies. Today, they have the largest. Have the departments grown smaller or weaker? No; the problems have grown larger and quite immune to skillful detection. If we cannot look to the traditionally great states for inspiration, can we look to the feds? Not with their record in simpler financial businesses. Can we look to the state guaranty funds or post-assessment rights? Not for this kind of money.

So we come back to the big choice for the states. Will they embrace the inevitable and live with the vicissitudes of an industry shaking out a lot of excess and unstable capacity in order to attain stability in the long run? That takes a lot of patience and a lot of political staying power. Or will the states take a protectionist or parental attitude to protect the industry from itself? We may laugh at that alternative, but government has done just that, over and over in many industries, feeling superior to the sellers it serves.

Nowhere in our economy is this choice more stark than in insurance. Nowhere is it more in the hands of government. And how unprepared government is. The feds know only that they want the best of all worlds, however irresponsible: forced competition and monopolistic regulation. The states may end up with futile and servile regulation adopted only to keep the feds out, and eventually embarrassing everyone enough to bring the feds in.

So the future of insurance regulation is not bright, except for one thing. In this great pluralistic society, we tend not to follow to logical conclusions, especially where they are silly enough. Insurance is a fine example.

So eventually the state commissioners and legislators will opt for competition and innovation. They will do so not because they are visionaries or heroes, but because nothing else will work. They will dare to get federal help where they need it, on such matters as preempting atavistic rate regulation. Thus, they will go on and do the job of insurance regulation about as well and badly as before. But most important, they will be going in the inevitable direction.

Seeing Ourselves As Others See Us

When the insurance business comes under public attack, its first defense is to explain itself. The underlying assumption is that our story is so good that once people understand it, they will leave us alone.

Now the attack is deadly, and the defense is not working. We should approach the challenge the other way around, by figuring out why the public thinks and acts the way it does about insurance. A good place to start is automobile insurance which, as seen in the consumer revolt in California and elsewhere, is high on the public agenda. And public attitudes about the auto insurance business have parallels in other lines.

Underlying the debate over Proposition 103 and similar proposals is the question of who is to be held responsible for the results of the auto insurance system. The system has two parts — compensation rules and insurance. Both parts embody certain principles, such as legal liability and cost-based pricing, and both parts impose running costs. Each part is primarily operated by a major service industry — the law business and the insurance business.

In part, the auto proposals are a chapter in the struggle between the two service industries to pin the blame on each other for the unsatisfactory aspects of the total compensation system. Today the fight centers on whether the insurance industry should be allowed to allocate the costs of the system according to insurance principles.

But the appeal of the proposals is not so much to theorists of any persuasion. The appeal is aimed at ordinary people, directly through initiatives and indirectly in the legislatures. Like many strong political appeals, it is essentially negative. What people do not like about auto insurance most of all is its price — absolutely and in relation to their ability to pay and to the benefits they get.

The political process is a legitimate mechanism for allocating costs and benefits in our society. One reason the insurance industry has had trouble dealing with the auto insurance proposals may be that the industry has not fully examined the way the insurance questions tie into the political system. It may therefore be helpful for insurers to step back and put the questions about auto insurance into the political context.

The ideas that impel people to support initiatives and revolts like Proposition 103 can be expressed in a few sentences: "Automobile insurance is a tax. It is high

with Barbara D. Stewart and Richard S. L. Roddis
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and unfair. It doesn't do much for me. When insurance companies pick on me, government doesn't protect me. Read my lips."

While the focus here is on automobile insurance, this reasoning easily can be applied to other lines of insurance as well. Then it is a simple step for consumers to move from dissatisfaction with the product and its price to distrust of the industry and its regulators, followed by the urge to take matters into their own hands.

Analogy To Taxes

A tax is a payment required by the government of a society as a condition to taking part in that society. Most communities in the United States are so spread out, and have so little public transportation, that people must have a car in order to take part in society. By law, directly and through liability rules, insurance is needed to operate a car. Financial responsibility laws, and especially compulsory insurance, make clear to the citizen that he has no choice. If he is to drive, government requires that he pay a private insurance company for the privilege.

Seen as a tax, auto insurance is somewhat like a toll or excise, as the payment relates to the privilege of driving. It is also similar to a property or income tax, as the benefit of insurance itself is not immediate or clear. The system of required insurance is partly like modern taxes, since it is a payment that government exacts, but it is also like tax farming, the ancient sale of government taxing power to private organizations.

As we can see, auto insurance has many aspects of a tax, and the specific analogies are not at all favorable. Insurance debates often sound like tax debates and call forth the same emotions.

Questions Of Fairness

The question of fairness turns up at the center of debates about public policy regarding taxation, utility profits, labor relations and regulation of many kinds. The word "fair" sounds as though it expresses a standard when it really expresses a conclusion. When the word figures prominently in debate, it usually means the debate is nearing a conclusion and is about conduct which is not entirely private. The price of cars is not analyzed as fair or unfair; the price of car insurance is.

In a public policy context, fairness connotes equal treatment subject only to distortions based on other public policies, such as ability to pay or matching costs with benefits. Fairness has little to do with pricing against costs, which is a statistical and competitive principle. Pricing against costs tends to make fairness issues more troublesome. It leads to refinement of rating classifications, which makes price disparities wider. It also leads to classification features that, while statistically

sound, either conflict with other social goals or are not intuitively relevant. Among them are age, sex, residence and policy persistency.

Fairness issues are made worse by the dependence of auto liability insurance on the law of liability. For that reason alone, the system is regressive in its allocation of costs, and its benefits are uncertain and delayed.

For the individual, a calculation of his own costs and benefits will often make insurance seem a bad deal, in three ways. First, if they have had no claim, many people consider their insurance to have been wasted. Even when they do have a claim, they may underestimate the value of defense. Arriving at a liability settlement with a stranger is less satisfying than buying something tangible or paying oneself.

Second, the waste and capriciousness of the tort system become real through the premium. Only the sophisticated know what goes into those premium charges and how the benefits which get through the system are distributed. For everyone else, it is just money that disappears into the insurance company.

Finally, if the individual is poor he knows he has little at risk in civil liability situations. His premiums are going to pay someone else who is, on the average, better off than he is.

Mystery And Trust

By familiar measures — revenues, assets, capital, jobs — the insurance business is big. In auto insurance, the large firms are very large indeed. Large private corporations may be admired and trusted individually, but American business lore favors small business and calls up fear of big business and its presumably concentrated power.

Size poses dilemmas for auto insurance companies in tense public situations. If they pull out of a hostile state, they are seen as bullies. If they stay in, they are rich enough to defy anything. If they explain their situation, they are manipulating the public mind; if they shut up, they are being secretive.

Insurance pricing is mysterious. The prices of consumer goods are explicit and usually stated as so much per unit. The price of consumer borrowing is set out in a standard form. A seller's price is the same for all consumers.

Auto insurance prices, on the other hand, vary with characteristics of the buyer which are usually not stated. Component costs, and their relation to prices, are not stated. The customer is left alone with the press, politicians and his own imagination. This is so different from what he is used to elsewhere that he may take seriously charges that the insurance companies do not want him to know.

Profits made by insurance companies, particularly the investment income component, have been a cause of mistrust for at least 80 years. Conservative rules of insurance accounting, which disregard the time value of money and take going concern values off the balance sheet, also undermine trust. Here, insurers have behaved differently from bankers, who have long acknowledged they made money on deposit float, and whose accounting is simpler.

Behaving differently, and maintaining that one is different, involve the risk of being treated differently in an unfavorable way. The outcome is made more likely by people's tendency to suspect that if a business obscures its profits, they are probably too high.

Anyone in the business knows auto insurance is highly competitive. But the cartel history of fire insurance, the pooling of data in casualty lines and the special antitrust status of the industry all point the other way. It has become too easy to blame high prices and restricted supply on a conspiracy. Having a special dispensation for agreement among competitors is just asking for it.

Doubting The Regulators

State insurance departments have long been involved in ratemaking. They examined the boards and bureaus and passed upon their rules. From the 1940s many of them approved rates, in a market where bureau rates were tightly related to consumer prices.

Today, in much of commercial insurance, rates have less to do with prices and there are too many pricing points to regulate. Yet in the commercial insurance crisis of the 1980s, the regulators were generally held responsible for the results of the system, whether or not they could do anything about it.

In auto insurance, the regulators are being held responsible for the results of the system, even though they have no control over the legal and medical cost systems which drive it. When premiums are seen as too high or unfair, the regulators are found wanting. Sometimes the regulators have not done all they could or have not done it consistently or responsibly. But that is not why they are held accountable. They are held to account because they are there.

The most vulnerable aspect of rate regulation is the idea of leaving the market alone so that competition can determine prices. Never mind that the economic evidence is overwhelming. Once the public becomes convinced that insurance is different and that the regulator is responsible for what the industry does, it is nearly impossible politically for the regulator to maintain that, faced with an unsatisfactory outcome, he is doing best by doing least.

Resignation to an unsatisfactory state of affairs is not a prized trait in the American character. People do not want to hear that the regulator is doing the best he can and things are still bad. It is easier to search for villains. The effort by some academics and regulators to blame the tort system largely failed. The effort by the insurance industry to blame the lawyers not only failed but led to the present retaliation.

Now the insurance industry is being blamed. Since part of the argument is that insurers cannot be trusted, public agencies are expected to keep them in check. Judged by the unsatisfactory results, they have not done their duty. Therefore, public agencies must be villains as well.

An irony of Proposition 103 is that it happened in a state where regulation so fostered competition that low-cost, low-price insurance companies had won most of the market. But auto insurance is so important and inherently so political that it does not matter how efficient auto insurers are or how low their profits. Nor does it matter how vigorously insurers explain themselves, for the struggle is not over what is being said but over who should be saying it.

The lawyers, consumer groups and grass-roots activists have the upper hand. None of these groups controls the other, although just now they have a community of interest. Of the three groups, only the lawyers are vengeful, and that may give way to their economic interest in the health of their funding mechanism.

Unfortunately for insurers, the three groups arrayed against them are the most accomplished controversialists in the picture. Insurance companies, like other business corporations, are not good at public debate in a political setting. Nor can insurers count on a lot of help. Regulators are seen as part of the problem. Agents are sitting it out. State legislators will try to head off more direct democracy. Congress will serve as a forum for discontent, before doing something symbolic about McCarran.

The allocation of other people's money is an attractive activity for any legislature with no uncommitted money of its own. Politicians have long gotten away with letting insurers make social decisions and constituency trade-offs which are really a political responsibility, and then criticizing whatever the insurers did. Politicians would lose that luxury if insurers stayed neutral on more social issues and just declared their willingness to compete within whatever rules the makers of public policy laid down.

Business in the 1980s has become notorious for a short-term preoccupation with one's own bottom line. Prominent victims of that preoccupation were financial institutions, which depend on relationships and which do best when they look upon profit as a result of a good job rather than as the job itself. It is no accident that

today's struggle over auto insurance comes at the end of the 1980s, and the public's short-term bottom line is the threat.

The 1980s are also known for the removal of accumulated equity from businesses. This was done to increase the return on what equity remained or to use aggressively the power to borrow or just to do deals. For our analysis of the struggle over auto insurance, what matters is that this practice made fashionable the one-time taking, for private purposes, of accumulated wealth built up over the years. The threat now is a taking for what are declared to be public purposes, a gradual expropriation.

Some of the threats we have discussed are unique to the auto line. But public restlessness does not stop there. Even the movement of corporate buyers toward alternative mechanisms, which began as a financial exercise, may now be taking on aspects of a consumer revolt.

The struggle over auto insurance may thus be part of a larger struggle. The larger stakes may be control over the big decisions in insurance, whatever those decisions are from line to line. If so, we have all been warned.

In a consumer-oriented democracy, perhaps the best a business can hope for is to be tolerated. It may be presumptuous for a business like insurance to expect to be loved. But today's estrangement of the industry from society could be the most costly in its history. What the number-crunching 1980s forgot was that the most precious capital for a financial service institution is social, not financial.

High Stakes

The worst threats to that capital are social threats. Today's struggle over auto insurance is central and not just on the political periphery. The end of the struggle could be the dismissal of insurance to the role of the dullest kind of public utility, inefficient and unprofitable, passive and sullen, whose only virtues would be predictability and subservience. In any fight, it is useful to be aware of the down side and for insurers that is it.

The stakes cannot get much higher for a private business. The outcome is not under the control of any one interest or point of view. But it will be influenced by how shrewdly the insurance industry responds. That effort begins with the hardest step — seeing ourselves as others see us, even if we do not recognize or like what they see.

A National Guaranty Fund

Because insurance is crucial to the workings of our economy and society, the insolvency of an insurance company is economically and socially disruptive. Those hurt the most are policyholders left with unpaid claims, which can amount to hundreds of times what was paid out in premiums.

Judging by the insolvency record, the states have done a good job of regulation. There have been relatively few rashes of insolvencies in the past except for three episodes. In each of these episodes, the industry and the federal government took action to limit future damage to the public.

Now a fourth episode threatens. If it strikes, it will create insolvencies of a scale and character not previously encountered. The strategies that proved successful in coping with the previous three insolvency episodes will be unequal to the task of limiting this new kind of insolvency. Action to contain the damage will require a fresh, national approach.

The First Three Episodes

The first of the three previous insolvency episodes occurred in the latter half of the 19th century and involved fire insurance. Such coverage was central to the building of cities and industry, but it bankrupted many insurers when devastating blazes erupted. The solution was to fix rates high enough that insurers could absorb the occasional disaster.

The second episode took place during the Depression, when stocks, bonds and real estate lost much of their value and many banks went under. Insurers writing mortgage guarantees and surety bonds on bank deposits also failed. The solution was to do away with the need for those kinds of private insurance.

The third episode involved substandard auto insurance in the late 1950s and early 1960s. Competition among large auto insurers wrought profound changes in this line, leaving inner-city drivers with higher rates or no coverage at all. Small carriers sprang up to meet the need, but many went under. The response was to act directly to reduce public harm by rescuing companies and by creating insolvency guarantee funds.

These three insolvency episodes had much in common. The insolvent companies were small and generated commensurately modest insolvency losses. The insolvencies were local and not connected to one or other. And they were simple and easy to resolve.

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The question now is whether a new wave of insolvencies is approaching. If it is, what is its character, can it be prevented and how can the cost to society be minimized?

The signs are that we are heading for trouble, and trouble of a predictable sort. Thus far, the states' insolvency batting average has been good. But the insolvency record reflects the entire insurance mechanism, of which state regulation is only one part. Other important factors are the structure of the industry and the economic environment in which insurers operate.

For the first half of this century, the structure of the industry kept rates up. As that structure dissolved, the post-war economic boom provided a favorable environment for premiums, claims and investments.

We will never know how much of the solvency record is a function of regulation and how much is due to a supportive structure and favorable economic environment. But nothing in the record suggests that a wave of insolvencies cannot happen here and cannot happen now. Nor does the record imply that regulation, even improved regulation, can make a new wave of insolvencies improbable.

The fourth wave of insolvencies we appear to be facing will focus on general liability insurance. This line accounts for only 11 percent of the industry's premium volume, but its capacity for mischief can be seen in the insolvencies of American Reserve, Mission, Transit, Integrity, Ideal, Midland and American Mutual of Wakefield, and in the events unfolding at H.S. Weavers in London.

Why general liability? Because of the open-ended nature of these risks, the time it takes them to develop, and the consequences of a dynamic and demanding legal system. Reserve deficiencies are large enough to hit insurers' balance sheets with the impact that conflagrations did in the 19th century. Yet insurers are attracted to general liability because it is one of the few markets that is still growing and not overcrowded.

The record of recent general liability insolvencies suggests that future ones are apt to be large and may involve larger companies. They are likely to be complex as well as national and international in scope. And they will take decades to resolve.

It seems unlikely that we could solve this next insolvency problem by either of the first two solutions employed to counter earlier crises—subsidizing rates or eliminating private insurance entirely. Nor is it likely that we would just let the losses fall where they may, because they penalize innocent claimants who had nothing to do with picking the liability insurer. Most likely, we would take the third approach and act directly to minimize harm to the public from such insolvencies.

Much of our present system to minimize harm is equal to the task. Over the years the states have built up expertise in the detection of insolvency, including conservative accounting, periodic examinations and statistical early-warning indicators. This system should be preserved and strengthened.

But the present system was built on experience with small, local and easily isolated insolvencies. Rescuing individual companies had a good chance of success, and the public did not lose much when the regulator tried and failed. When a company went under, the states could control the damage through their own liquidation and guarantee resources.

A New Kind Of Failure

All this is changing. The coming insolvencies in general liability will be large, national, complex and interconnected. With this new kind of insolvency, a regulator's delay in attempting a rescue will be less rewarding and more costly. The state system of liquidation and guarantee funds is inherently ill-suited to this new kind of insolvency.

Therefore, simply improving state solvency regulation will not do the job. To be effective now, the system must be changed in concept and structure.

Only a combination of early detection, prompt action and guarantees against loss can deal with a wave of general liability insolvencies. But guarantees do not come without cost — both directly in costs to insurers, and indirectly in altering the balance of risk and reward for managers, policyholders and regulators. Guarantees will be beneficial, but they must be designed carefully.

Five principles should govern the design of a guarantee program: the program should build on the existing structure of the industry and its regulation; the liquidation of insolvent companies and the guarantee of their obligations should be national in scope; insolvency costs should be charged back to the activities causing them; the system should encourage close monitoring of the companies' financial condition; and the national program should assign significant roles to the state insurance departments and the private insurance industry.

Based on these five principles, Stewart Economies has set forth a concrete proposal for a national system of liquidation and guarantees in a report titled "Insurance Insolvency Guarantees."

Under the proposal, an act of Congress would create a National Insurance Guaranty Corporation (NIGC). Like the state funds, the national fund would be privately financed by assessing insurers, and charging guarantee costs back to carriers in the state and line of insurance involved. In addition, NIGC guarantees

would be designed so that policyholders, brokers, reinsurers and others in the private sector would have financial incentives to maintain close surveillance of the financial condition of insurance companies.

The NIGC would not be a regulatory agency. Responsibility for insurance regulation, including detection of insolvency and action to take over companies, would remain with the states. Nor would the NIGC rescue insurers. It would serve only as a rehabilitator or liquidator of companies already placed in receivership by state regulators and courts. The NIGC's guarantee obligations, and its power to assess members to fulfill them, would extend only to policy claims owed by insolvent companies in liquidation.

The idea is to combine the strengths that private industry, the state regulatory agencies and the federal government can bring to this emerging challenge. Whatever its exact shape, a plan of action should be decided on now while events are still within our control and there is still time to make balanced and calm decisions.

Suppose the Clinton Administration Looks at Insurance Regulation

The arrival of a new national administration challenges us to think about what it means for insurance regulation. We can do so out of mixed motives of patriotism, self-improvement and self-defense.

Insurance regulation, taken by itself, is bound to be low on the administration's priority list.

Yet many matters high on the list have a lot to do with insurance. Among them are the national economy and health care financing. The new administration will ask what insurance contributes to, or takes away from, those larger efforts. Coming from a campaign focused on economic matters, the new administration is likely to think in economic terms, that is, in terms of efficiency and productivity.

For our purposes, it is good to separate two questions and to ask them one at a time. The first is narrow. How well is insurance working, taken as just the business and its regulation? The second is broad. How successful are the larger systems of which insurance is a part?

Those two questions or subjects — insurance by itself and insurance within larger systems — are two different questions. Framing a question is a long stride toward the answer, and it is important in making government policy to see that these are two separate questions. We often mix them up, witness that the campaign argued the health care issue, the health care financing issue and the health insurance issue as though they were the same.

Of the two questions, the second, having to do with systems of which insurance is part, is the more important and more interesting, but the narrow question should come first.

On that first question, how is insurance itself doing? Not badly. One measure is efficiency, and during the past fifty years, the insurance business has certainly become more efficient. The overhead expense of distribution, administration and loss adjustment is down significantly at companies and agencies. Even larger savings have come from competitive displacement of one way of doing business by another — individual sales by group, intermediaries by direct, bundled services by risk management.

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But were our standard the productivity gains which remade agriculture and manufacturing in the last two hundred years, then insurance, like other service industries, would seem to be just at the threshold.

Evolutionary progress in the efficiency of insurance will continue to be driven by economic forces, chief among them innovation and competition. By contrast, an industrial-scale, quantum leap in efficiency would require a radical restructuring of the insurance business.

Such a quantum leap would likely require streamlining of underwriting and rating, eliminating steps in distribution and service, simplifying decisions about claim payment and other policy benefits, centralizing or sharing transaction flows to obtain economies of scale, standardizing contracts fully and openly, and removing routine disputes from the courts.

There are precedents for that sort of thing in this country and elsewhere, but it would be a mighty big step and not one to be taken lightly. Most important, those with the power to take it should be mindful that it could not be accomplished by working on the insurance business alone, but only by reform of the larger systems of which insurance is a part.

That brings us to the second, and more interesting, question — insurance as part of larger systems of funding and allocating costs and benefits in our economy and society. That will be of more concern to the new national administration than the working of the insurance business and regulation alone. What will the administration see when it looks at insurance with that broader perspective?

Once again framing the question in economic and historical terms, insurance exists at all because it contributes more than it takes out, because it is productive for others.

In property-casualty, the combination of loss spreading, loss control, indemnity payment and statistical prediction has made insurance worthwhile for individuals and business firms. Life insurance has offered the most effective way to spread the financial risks of death and to save for old age. In health, insuring has been a better bargain than going it alone for both the consumers and providers of care.

The new national administration has goals which call heavily upon the systems and programs of which insurance is a part — better health care financing, fuller provision for old age, lower cost burdens on competitive industry, a more reliable transportation infrastructure, more open opportunities for all. With the fine tradition of insurance in contributing more than it takes out, and with the industry's

own efficiency improving, a new administration might not be fully braced for what it will find in those larger systems. Consider four examples.

Example one — health. Much of the insurance business there is highly efficient and imbued with public spirit. Much of it is creative and entrepreneurial. But need we recite the results of the working of the larger system and the propensity of plausible innovations, in insurance and elsewhere, to disappoint and backfire? Yet health care financing is explicitly at the top of the national agenda and it can be a barrier to attaining other objectives of family well being, economic competitiveness and a society more open to individual worth and effort. Insurance is certainly part of the problem, and it may offer incentives for the rest of the system to work worse.

Example two — automobile insurance. To hold a job, many workers need a car. Insurance is compulsory. Auto insurance tends to cost more in dense urban areas. That is not where the richest people are. So the costs are allocated regressively. And the costs contain a lot of transaction expense. You know the case against the present compulsory liability insurance system. But to someone coming to it afresh, and seeing it as part of the transportation infrastructure, the accident insurance system will look like an obstacle.

Example three — workers compensation. Workplace injuries mean suffering, unproductive expense and a bidding up of health care prices. The workers compensation system, despite a brilliant history, now defeats many of its original purposes. It distorts cost and benefit allocation and imposes plenty of direct and indirect overhead of its own. It encourages the best risks to opt out. For the remainder, it seems condemned to charge employers too much, pay workers too little and starve insurers of the revenue they need. To someone looking afresh at American economic competitiveness and access to health care, it looks like another obstacle.

Example four — general liability. Once stable and profitable, now it gyrates in price and availability. It devours money and time in coverage litigation. It lies behind most casualty company insolvencies. Regardless of the rights and wrongs of particular price movements, company insolvencies and coverage disputes, a business that exists to reduce uncertainty, and thereby to conserve industrial capital, is in practice adding uncertainty and consuming that capital. To someone looking anew at industrial and environmental policy, the liability insurance system looks like one more obstacle.

Now those are only four examples, but the four systems are sick, and within each system the insurance piece has not always been helpful. In all four, insurance regulation has been unable to reach the fundamental problems in the larger systems, and concentrating regulatory power on the disagreeable symptoms has tended to make the fundamental problems worse.

Mind you, the insurance business is innocent of much of the malfunctioning of the larger systems. So is regulation.

But not always. Federal and state office holders often yield to the temptation to regulate symptoms rather than causes, with small regard for deferred costs and system damage. For states it usually comes up in the form of regulating rate levels, rate relativities and the relationship of rates to the ability to pay. At the federal level, it usually comes up in granting exemptions from federal taxes and from state jurisdiction.

Insurance is just another area where the desire of officials to confer benefits has outrun their, and the voters', willingness to face costs. Regulation, good and bad, is always a political activity, and this is one area where the record is not good.

We are not here to assess blame, but rather to anticipate how a new national administration is apt to deal with our world. The record of cosmetic regulation at both levels of government should warn the new administration about temptations of its own to view insurance as just something to be manipulated. But everywhere it looks, insurance is there.

Whether a national administration is thinking about family well-being or about international competitiveness, it will deal with costs allocated by insurance and costs added by insurance. It will think about insurance sometimes as a separate subject but more often as a part of larger systems. It will touch insurance as part of larger programs. Insurance will be seen as an implement or an obstacle, not as a subject or a goal.

The new administration will have quite a different angle of approach than regulators usually do and than Congress usually does when overseeing regulators. It is almost like the two ends of a telescope. The new administration will see insurance in little detail but full context. Regulators will have full detail but a narrower view. Yet it is in the interest of both to try for a common perspective. That perspective almost has to be to look at the entire systems and to try to help them, once again, contribute more to the economy and society than they remove.

Adopting a larger view and making policy out of it is difficult. But not impossible, and it is not without precedents in our field.

When fire insurance became too important to leave so unreliable at the point of claim, the states developed the standard fire policy. When life insurance grew with no goal but size and the enrichment of salesmen and insiders, the states imposed modern fiduciary ideas. Early universal health insurance and early no-fault auto insurance legislation was drafted in regulatory offices.

There are precedents as well for finding common ground with the federal government. It is easier in the panorama of national policy than in the ominous corridors of congressional oversight. The best example in the past is the cooperation on regulation itself among Congress, the Roosevelt administration, the NAIC and the industry after the *Southeastern Underwriters* case. Another example is the cooperation on making essential insurance available in the aftermath of the riots of the sixties.

So even if the new administration never takes up insurance regulation directly, it will implicitly place before regulation two serious challenges. One is to look at insurance as part of larger systems. The other is to find ways to cooperate with the national government on program without being overwhelmed by it on regulation. Both challenges can be met, and state regulators have a lot to contribute on both and can benefit from the effort even in the exercise of their conventional duties.

A specific example of their ability to help on program is in sorting out what can and cannot be accomplished by government power and what can and cannot realistically be demanded of the private insurance business. If the issue is whether to supplant private business or force a restructuring upon it, then the issue can be debated in those terms. The danger, as with cosmetic regulation, is that it will not be seen for what it is, so that an issue of replacement will be couched in terms of guidance. But sometimes the wolf really is at the door, and regulators have an experienced ear for telling real from ritualistic cries.

So the challenges of seeing insurance as part of larger systems and of separating regulation from program can be met. If they are, the new administration, state regulation and the insurance business will be better for it. If not, the risk to all three is that an action-oriented administration will identify the business as an obstacle to achieving national goals and will identify regulation as an obstacle to getting at the obstacle. That, needless to say, would not be good for either the business or regulation and, quite likely, not for the chances of the administration to succeed in the long run.

Better for us all to try for a common perspective on these great risk-bearing systems and on the programs, state and national, to ready them for the future. The initial step is in our minds, and so we can begin without even waiting for the new national administration to take the oath of office.