Studies done by the Association indicate that no significant tax revenue would result from elimination of the PAL account. On the other hand, elimination of the PAL deduction would likely result in substantial disruptions and distortions in competition between stock and mutual insurers. The Draft Report fails to weigh these facts.

CONCLUSION

The Associations appreciate the opportunity extended by the General Accounting Office to comment upon the Draft Report. The Associations will be pleased to discuss their comments with the staff of the GAO.

Respectfully submitted,

Alliance of American Insurers
National Association of Independent Insurers
National Association of Mutual Insurance Companies
Reinsurance Association of America

OBSERVATIONS ON THE APPROPRIATE TAX TREATMENT OF FUTURE COSTS

by Emil M. Sunley

Emil M. Sunley is Director of Tax Analysis in the National Affairs Office of Deloitte Haskins & Sells in Washington, D.C. He served as Deputy Assistant Secretary of the Treasury for Tax Analysis from 1977 to 1981.

In this article, Sunley critiques recent Treasury testimony relating to the tax treatment of mining reclamation costs and loss deductions claimed by casualty insurance companies. As Sunley points out, the questions raised by that testimony have important implications for similar questions arising in connection with the tax treatment of expenditures for product liability and warranty claims, nuclear power plant decommissioning costs, and the costs of dismantling offshore oil rigs.

While agreeing that the Treasury's analysis of future cost issues is correct in the case of ordinary business expenses, Sunley concludes that Treasury is incorrect when a future payment is an investment outlay that must be incurred if income is to be earned currently. He also concludes that Treasury's analysis of the appropriate tax treatment of casualty insurance companies is incomplete.

Recent Treasury testimony has focused on the time value of money in determining the appropriate tax treatment of certain future payments. For example, Treasury has opposed mining companies taking a current deduction for estimates of future reclamation payments.[1] Treasury has also opposed casualty insurance companies taking a current deduction for future outlays.[2] Instead, Treasury has suggested that delaying the deduction until the expense is actually paid always produces the correct result. Alternatively, Treasury has suggested that taxpayers could be allowed a current deduction for the discounted amount of the future outlay. The future outlay would be discounted at the after-tax discount rate, and no further deduction would be allowed.

[1] Statement of John E. Chapoton, Assistant Secretary of the Treasury (Tax Policy), on December 7, 1982, before the Subcommittee on Energy and Agricultural Taxation of the Senate Finance Committee. See also, the Statement of William S. McKee, Acting Deputy Assistant Secretary of the Treasury (Tax Policy), on May 23, 1983, before the same subcommittee.

[2] Statement of John E. Chapoton, Assistant Secretary of the Treasury (Tax Policy), on June 13, 1983, before the Senate Finance Committee.

The Treasury testimony has broad implications not only for the tax treatment of mining reclamation expenses and casualty insurance liabilities, but also for the tax treatment of expenditures for product liability and warranty claims, costs of decommissioning nuclear power plants, and the costs of dismantling offshore drilling rigs.

The general thrust of the Treasury testimony on the "premature accrual" of future liabilities has been accepted by the Joint Tax Committee. Last June in a pamphlet prepared for the Finance Committee, the Joint Committee suggested that the

> "accrual rules could be amended to provide that an expense is not currently deductible unless the recipient of the payment is known and the taxpayer has a present liability to make the payment. Another alternative would be to require taxpayers to report certain deferred payment transactions using the cash method of account."[3]

The Committee on Taxation of the New York City Bar Association also recently examined the tax treatment transactions involving deferred payment of accrued liabilities.[4] The Committee concluded that (1) substantial economic distortions may be produced under existing law in some important cases, (2) this subject deserves urgent attention, and (3) legislative solutions may be required.

In this paper, no attempt is made to provide a comprehensive survey of the appropriate tax treatment of future outlays. Instead, the focus is on the analysis contained in the Treasury testimony relating to mining reclamation and casualty insurance. To anticipate the conclusion, the

[3] Joint Committee on Taxation, "Background on Tax Shelters," Joint Committee Print, June 23, 1983, p. 18.

[4] Committee on Taxation of the Association of the Bar of the City of New York, "Transactions Involving Deferred Payment of Accrued Liabilities: Federal Income Tax and the Time Value of Money," *Tax Notes* (August 29, 1983), pp. 699-714.

Recent Treasury testimony on mining reclamation and casualty insurance has confused the issue of the appropriate tax treatment of future costs.

Exhibit A

APPENDIX III

Treasury (and the Joint Committee) analysis is correct when the future payment is an ordinary and necessary business expense,[4] but the analysis appears to be incorrect when the future payment is an investment expenditure that must be incurred in the future if income is going to be earned currently. Moreover, the Treasury analysis of the appropriate tax treatment of casualty insurance companies is incomplete, and incorrect, because consideration was not given to the appropriate tax treatment of the insured.

What follows is a simple example of an investment that yields positive cash flow for a number of years and then requires a significant outlay at the end. The example is used to examine the appropriateness of alternative tax treatments of the final outlay. This example could represent an investment in surface mining, a nuclear power plant, or an offshore oil rig.[5] These investments have significant negative salvage value, that is, the costs paid at the end for reclaiming, decommissioning, or dismantling exceeds the value of the salvageable materials. It should be noted that the positive cash flows cannot be earned without incurring the negative outlay at the end. For example, to obtain the positive cash flows from a nuclear power plant the plant must be turned on. Once it has been turned on, some type of decommissioning will be required at the end of its operating life. Similarly, once land has been disturbed by surface mining, state and federal environmental laws require mining companies to reclaim it.

Consider a $3,000 investment that yields positive cash flow of $1,000 per year for five years and then requires "dismantling" expenses of $1,401. This investment in a world without taxes would have an internal rate of return of 10 percent as shown below.

TABLE 1

Year	Cash Flow	Present Value (r = 10)
1	$1,000	$909.09
2	1,000	826.45
3	1,000	751.32
4	1,000	683.02
5	1,000	620.92
6	-1,401	-790.82
		$3,000.00

Economic Depreciation

The issue concerns the appropriate tax treatment of the final outlay of $1,401. Treasury has argued that this outlay should be expensed in the year paid. I suggest that a proper matching of income and expense requires that the final outlay be "depreciated" over the life of the investment. Tax depreciation (or capital recovery) is neutral, as Paul Samuelson has shown, if (and only if) the true loss of economic value is permitted as a tax-deductible depreciation expense.[6] Moreover, if economic depreciation is allowed, the effective tax rate is equal to the nominal tax rate.

[5]It does not represent the case of casualty insurance, which is discussed later.

[6]Paul A. Samuelson, "Tax Deductibility of Economic Depreciation to Insure Invariant Valuations," *Journal of Political Economy* (December 1964).

Economic depreciation can be determined by discounting for each year the remaining before-tax cash flow to the beginning of that year using the before-tax discount rate.[7] Economic depreciation is then equal to the change in the present value of the future cash flow.

TABLE 2

Year	Cash Flow	Present Value of Future Cash Flow Discounted to Beginning of Year (r = 10)	Depreciation[a]
0	-$3,000	$3,000.00	
1	1,000	2,299.95	$700.05
2	1,000	1,529.95	770.00
3	1,000	682.95	847.00
4	1,000	-248.77	931.72
5	1,000	-1,273.64	1,024.87
6	-1,401	-1,401.00	127.36
			$4,401.00

[a]Equal to the change in the present value of the future cash flow.

The interpretation of the third column of Table 2 is fairly straightforward. At the end of year 0, someone would pay $3,000 for this investment. At the end of year 1, once the first $1,000 of positive cash flow has been realized, someone would pay only $2,299.95 for the future cash flow. At the end of year 4, the value of the future cash flow has become negative. That is, the owner of the investment would have to pay someone to take the investment off his hands. The reason for this, of course, is that the present value of the future detriment (the $1,401) is greater than the present value of the future positive cash flow—the $1,000 at the end of year 5.

The Treasury . . . analysis is correct when the future payment is an ordinary and necessary business expense, but the analysis appears to be incorrect when the future payment is an investment expenditure. . . .

It should be noted in the last column of Table 2 that economic depreciation permits $4,401 of capital recovery over the life of the project. Put another way, economic depreciation spreads the $3,000 initial investment plus the $1,401 final outlay over the life of the investment. One might view this result as similar to what accountants call "negative salvage value depreciation" where the depreciable basis is equal to original cost less salvage value. If the salvage value is negative, the depreciation allowed over the life of the investment is greater than the original cost. It is equal to the original cost plus the negative salvage value.[8]

[7]It can also be obtained by discounting the after-tax cash flow by the after-tax discount rate.

[8]Whether negative salvage value depreciation would be neutral would depend on the timing of these deductions, not just the amount.

Table 3 demonstrates that if economic depreciation, as calculated in Table 2, is allowed, the effective tax rate is just equal to the nominal tax rate. For purposes of Table 3, a 50 percent tax rate is assumed. The after-tax rate of return is now 5 percent, which is just half of the 10 percent before-tax rate of return.

TABLE 3

Year	Before-Tax Cash Flow	Economic Depreciation[a]	After-Tax Cash Flow[b]	Present Value (r = .05)
1	$1,000	$700.05	$850.02	$809.54
2	1,000	770.00	885.00	802.72
3	1,000	847.00	923.50	797.77
4	1,000	931.72	965.86	794.26
5	1,000	1,024.87	1,012.44	793.26
6		127.36	63.68	47.52
6	-4,944			-$1,045.43[c]
				$3,000.00[d]

[a]Equal to the change in the present value of the future after-tax cash flow.

[b]Equal to $(1-m)R_t + mD_t$ where m is the marginal tax rate, R_t is the before-tax cash flow, and D_t is economic depreciation which is also the depreciation allowed for tax purposes.

[c]Equal to the present value of $1,401 discounted at 5 percent. The final outlay has no tax effect inasmuch as it has been depreciated over the life of the investment.

[d]The present value of the cash-flow is just equal to the initial investment.

The Appendix, *infra*, further explores the appropriate tax treatment of an outlay for mining reclamation or nuclear decommissioning. The criterion in the Appendix is neutrality between a normal investment (where the investment outlay is made only at the beginning of the project) and a negative salvage value investment (where a significant outlay is made at the end of the project).

Expensing—The Treasury View

The Treasury, as indicated above, maintains that expensing is the appropriate tax treatment of a required final outlay such as the cost of mining reclamation.[9] The Treasury argument, however, is faulty. Treasury's criterion for the appropriate tax treatment is a rule which would ensure that the amount charged by the seller reflects no more than the resource cost of completing the transaction. Treasury first assumes that in a world without taxes the discount rate is "r." When taxes are introduced, Treasury makes a fatal error when it assumes that the *after-tax* discount rate in the world with taxes is the same as the discount rate in the world without taxes. This assumption forces the conclusion that expensing or its equivalent (in present value terms) is required if the amount charged by the seller is not going to rise.[10] Expensing or its equivalent ensures that the before-tax and after-tax rates of return are equal. The effective tax rate is zero.

In contrast, if Treasury had assumed that the after-tax discount rate falls to (1-m) times the discount rate in the world without taxes where "m" is the tax rate,[11] Treasury would have concluded that the cost of the final outlay should be spread over the life of the investment in the pattern of economic depreciation.

[9]See testimony of John E. Chapoton, December 7, 1982, particularly the Appendix to that testimony.

[10]Actually, if companies can borrow at the before-tax discount rate and interest expense is deductible for tax purposes, companies will be able to lower their prices in a world with expensing compared to the world without taxes.

Casualty Insurance

The Treasury Department has applied its analysis of the time value of money to the issue of the appropriate tax treatment of the liabilities of casualty insurance companies.[12] Treasury concluded that the current tax rules which permit insurance companies to deduct the undiscounted estimate of their future claims are seriously flawed. According to Treasury, two alternative approaches should be considered. One method would be to defer the deduction until the insurance company actually pays the claim. Another would be to limit the deduction for unpaid losses to the discounted present value of the future payments.

Treasury supports its conclusion with a technical appendix which is a reworking of the appendix from the mining reclamation testimony. This appendix, however, is not applicable to the insurance case.

Casualty insurance in the simplest case involves the payment of a premium to cover losses incurred during the year. The actual payment of claims may be made over a period of years.[13] A reasonable tax treatment of casualty insurance must recognize that a loss has taken place during the year of the insurance coverage. For a proper matching of income and expense, that loss should be deductible by someone that year.[14]

Consider first a world without insurance. In order to stay in business, companies would have to set prices for their products at levels sufficiently high to cover expected casualty losses. Some companies would have actual losses, and these losses would be deductible for tax purposes. When all companies are considered together, however, the amount charged customers (and included in taxable income) for expected casualties would just equal the amount deducted by companies that had actual casualty losses.

Now introduce casualty insurance but assume that the insurance companies pay their claims the same year the losses occur. Companies would have to set prices for their products sufficiently high to cover the premiums for casualty insurance. These premiums would be deductible

[11]This assumption seems particularly appropriate if before-tax discount rate is equal to the cost of borrowed funds and interest is deductible. Investors will borrow at rate r as long as they can earn (1-m)r after taxes. It should be noted, however, that the before-tax discount rate in a world with taxes may be higher than the discount rate in a world without taxes. Even so, economic depreciation is required for the effective tax rate to be equal to the nominal tax rate.

[12]See testimony of John E. Chapoton, June 13, 1983. The Treasury may be rethinking this analysis.

[13]Casualty insurance typically does not provide that the insured party is covered for loss in present value terms. However, a policy could be written providing that in the event of a loss, the amount paid would equal the amount of the loss plus interest from the date of the loss. In this situation one would need to worry about the appropriate tax treatment of the interest income.

[14]Note that a taxpayer who self-insures may not be able to deduct the loss currently under the rules of accrual accounting because the amount of the loss cannot yet be determined with reasonable accuracy. Also note that the discussion does not apply to structured settlements where the amounts paid exceed the amount of the loss.

for tax purposes but would be included in the taxable income of the insurance companies. Assuming all companies are in the same tax bracket, the tax savings from the deduction of the premium would just equal the tax paid by the insurance company on the premium income. The insurance company also would deduct the amount of claims paid which would just equal the amount of insured losses. The companies would not include the insurance proceeds in income, because the proceeds are just a reimbursement. Taking all companies together, it should be noted that the casualty losses are deducted for the year in which the loss occurs, just as in the world without insurance.

Consider now the two Treasury alternatives for the world where insurance companies pay out casualty claims over several years. If the deduction is deferred until the insurance company actually pays the claim, there is a mismatch between the time when the loss is incurred and the time at which someone, in this case the insurance company, is able to take a deduction for the loss. If, instead, the insurance company takes a deduction up front for the discounted present value of the future payment, the full amount of the loss is never deductible. The logical implication of the Treasury position would be to permit the insured, to the extent casualty losses are deductible, to take a current deduction for the difference between the claim payment expected in the future and the present value of that claim.[15]

These present value calculations could lead to significant IRS/taxpayer disputes. Current law, which permits a current deduction by the insurance company for the expected claim, probably is a workable procedure. Insurance premiums should be set to reflect the fact that the full loss is deductible by the insurance company and no part of the insured loss is deductible by the insured even though the claim is paid after a lapse of several years.

Conclusion

Recent Treasury testimony on mining reclamation and casualty insurance has confused the issue of the appropriate tax treatment of future costs. In the case of the mining reclamation testimony, Treasury, by assuming that the after-tax discount rate in a world with taxes is the same as the discount rate in a world without taxes, assumed its conclusion that delaying the deduction for mining reclamation costs until the expense is actually paid always produces the correct result. In the case of the casualty insurance testimony, Treasury failed to recognize that a casualty loss occurs during the year of the insurance coverage. That loss should be deductible that year if income and expenses are going to be matched properly.

[15] Under the IRS regulations (section 1.165-1(d)(2)), no portion of a loss with respect to which a reimbursement may be received is sustained until it can be determined with reasonable certainty whether or not such reimbursement will be received. Taxpayers are not allowed to deduct the loss when incurred and then later include the insurance proceeds in income.

APPENDIX

That a future outlay for mining reclamation or nuclear decommissioning should be written off over the life of the project may become clearer if one compares two investment projects—one a normal investment where the investment outlay is made only at the beginning of a project and the other a negative salvage value investment where a significant outlay is made at the end of the project.

For convenience, the two investment projects may be considered an underground mine and a surface mine. Both projects yield a positive cash flow of $1,000 per year for five years. The underground mine requires an initial investment of $3,790.80, but requires no outlay at the end of the project. The surface mine requires an initial investment of $3,000 and final mining reclamation expenses of $1,401, essentially the example used in Tables 1, 2, and 3. Both investments have a 10 percent before-tax rate of return.

Given these two investment projects, a mining company would be indifferent between them in a world without taxes inasmuch as they both would yield a 10 percent rate of return. Given that these two investments have the same before-tax rate of return, the tax law should not favor one over the other.

If tax depreciation is equal to economic depreciation then the after-tax rate of return for both projects will be the same and the effective tax rate will be equal to the nominal tax rate. Table 4 demonstrates that the underground mine example has a 10 percent before-tax rate of return. Table 5 derives economic depreciation for the underground mine example. It should be noted that the pattern of economic depreciation is the same for the underground mine as for the surface mine. (Compare the last column of Table 5 with the last column of Table 2.) In both cases the total investment—$3,790.80 for the underground mine and $4,401 for the surface mine—is written off over the life of the project. Finally, Table 6 shows that with tax depreciation equal to economic depreciation, the after-tax rate of return for the underground mine is equal to 5 percent, the same as the after-tax rate of return for the surface mine, as shown in Table 3.

What do we conclude from all this? A proper matching of income and expense requires that the cost of mining reclamation (or nuclear decommissioning or oil rig dismantling) be written off over the life of the project. Delaying the deduction until the expense is actually paid does not produce the correct result.

TABLE 4

Year	Cash Flow	Present Value (r = .10)
1	$1,000	$909.09
2	1,000	826.45
3	1,000	751.32
4	1,000	683.02
5	1,000	620.92
		$3,790.80

TABLE 5

Year	Cash Flow	Present Value of Future Cash Flow Discounted to Beginning of Year (r = .10)	Depreciation[1]
0	-$3,790.80	$3,790.80	
1	1,000.00	3,169.88	620.92
2	1,000.00	2,486.86	683.02
3	1,000.00	1,735.54	751.32
4	1,000.00	909.09	826.45
5	1,000.00	0.00	909.09
			$3,790.80

[1] Equal to the change in the present value of the future cash flow.

TABLE 6

Year	Before-Tax Cash Flow	Economic Depreciation[1]	After-Tax Cash Flow[2]	Present Value (r = .10)
1	$1,000.00	$620.92	$810.46	$771.87
2	1,000.00	683.02	841.51	763.27
3	1,000.00	751.32	875.66	756.45
4	1,000.00	826.45	913.22	751.32
5	1,000.00	909.09	954.54	747.89
				$3,790.80[3]

[1] Equal to the change in the present value of the future after-tax cash flow.

[2] Equal to $(1-m)R_t + mD_t$ where m is the marginal tax rate, R_t is the before-tax cash flow, and D_t is economic depreciation which is also the depreciation allowed for tax purposes.

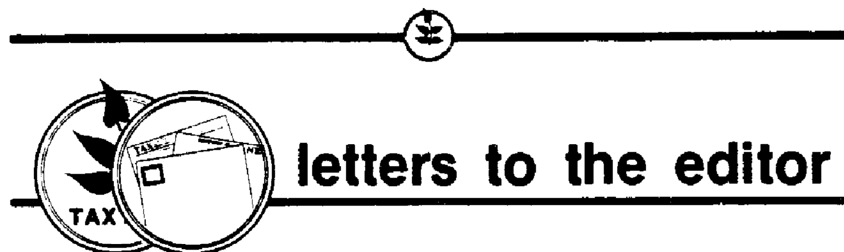
[3] The present value of the cash-flow is just equal to the initial investment.

COVERAGE OF FUTURE COST ISSUES

For a special report by the Association of the Bar of the City of New York entitled "Transactions Involving Deferred Payment of Accrued Liabilities," see *Tax Notes*, August 29, 1983, pp. 699-714.

For news coverage of the December 7, 1982 hearing at which Treasury presented testimony regarding the tax treatment of mining reclamation costs, see *Tax Notes*, December 13, 1982, pp. 878-879.

For coverage of the June 13, 1983 Finance Committee hearing regarding the tax treatment of losses incurred by casualty insurance companies, see *Tax Notes*, June 20, 1983, p. 1110.



GULF SAYS ROYALTY TRUSTS ARE LOSERS

Gentlemen:

This letter is in response to the letter entitled "In Defense of Royalty Trusts" submitted by Mr. J. F. Boros of Mesa Petroleum Company [See *Tax Notes*, February 13, 1984, p. 642.] As I am sure you are aware, Mesa has proposed that Gulf Oil Corporation spin off a royalty trust of approximately one-half of its U.S. oil and gas reserves. Gulf has concluded that there is little evidence to support the claims for value appreciation asserted in the Mesa proposal. On the contrary, we believe that the proposal, if adopted, would be detrimental to shareholder values because of: (1) the significant tax penalty that would be imposed on our individual shareholders upon distribution, (2) the severe economic damage that would be imposed on the remaining Corporation, and (3) the tremendous stock selling pressure that these factors would create.

The Mesa proposal incorrectly values the trust units and remaining stock by: (1) using misleading accounting procedures to recalculate Gulf's financial performance, (2) disregarding significant distinguishing characteristics among existing royalty trusts, (3) ignoring Gulf's prior trading history, and (4) dismissing significant adverse tax consequences by postulating perhaps the largest tax arbitrage in stock market history, which would require trading volumes for Gulf stock at unprecedented levels.

The myth that a royalty trust is all good things to all people is exposed by the discrepancy between Mr. Boros' allegation that there will be no revenue loss from the creation of a royalty trust and the statements of Mesa's Chairman, T. Boone Pickens, who is trying to sell royalty trusts on the basis that they will avoid federal income tax at the corporate level. Obviously, both of these Mesa spokesmen cannot be correct, and I am confident that when the Congressional revenue estimators complete their study they will confirm that the royalty trust proposed by Mesa would result in a substantial loss of federal tax revenues.

I am confident that . . . the Congressional revenue estimators . . . will confirm that the royalty trust proposed by Mesa would result in a substantial loss of federal tax revenues.

Of course, the entire tax scheme relating to royalty trusts depends on whether the IRS recognizes the avoidance of the corporate tax. At this time, there is reason to believe that the IRS will not condone such an avoidance scheme.

Very truly yours,

J. J. Ross
Chief Tax Officer
Gulf Oil Corporation

APPENDIX III

REMARKS OF Daniel J. McNamara

President

at the Thirteenth Annual Meeting of Insurance Services Office, Inc.

January 10, 1984

In previous annual reports at these meetings, I outlined ISO activities in a number of areas which, in my judgment, had considerable significance for the entire property-liability insurance business. I'm tempted to take a similar approach today because, indeed, the many insurer representatives who serve on our committees have accomplished an impressive number of innovative objectives over the past twelve months. Their deep interest and support throughout the year—to say nothing of the quality of their contributions—are gratefully acknowledged.

However, I've rejected the temptation to give you a full chronicle of ISO's 1983 accomplishments because those accomplishments, admittedly achieved with some detours and problems, have been documented through circulars and other forms of communication. Therefore, I'll touch on only a few highlights this afternoon because I want to take this opportunity to make a few personal observations on the financial condition of our business.

The watchwords for the next ten years for the winners in our business—and, in fact, for all business—are product differentiation and lower overhead costs. As a service organization, ISO has not ignored the realities of the business environment.

Last year, we completed development work on both occurrence and claims-made versions of the commercial general liability policy form.* The concept of alternative ISO products for insurers to use as they see fit reflects the realities of the marketplace, and, at the same time, rejects the "good old days" when *one* mandatory ISO product served as *the* answer to every need of buyers *and* sellers.

These new versions of the commercial general liability policy form are the result of an intensive review by many industry interests of an earlier exposure draft. That review—the most rigorous ever undertaken for a new ISO product—generated much attention and evoked controversial and diverse points of view. We appreciate the thorough, professional response provided by this group of industry interests, and each of their suggestions was carefully reviewed by appropriate ISO insurer committees. While we did not accept all the suggestions that were submitted, I believe the industry review process, while rigorous and time consuming, resulted in a better product for ultimate industry use.

The new policy form, which will be filed shortly with state regulatory authorities for a November 1 1985 effective date, modernizes the current general liability policy form. We modernized the form by consolidating many separate coverages into one broad contract that is appropriate for the typical risk in today's commercial insurance market. Except for the coverage trigger mechanism, its related provisions and the premium, the occurrence and claims-made versions are identical.

It's significant that the claims-made version is quite different from other claims-made policies now in the marketplace. For one thing, the new CGL claims-made policy gives insureds the right to buy "tail" coverage that extends the claim reporting period, without time limit, for injuries that occur before the policy is terminated. Also, that "tail" coverage will be available—with a maximum ISO advisory price in the manual—whether the insured or the company cancels or doesn't renew the contract for any reason other than premium non-payment. In addition, with no retroactive date, the claims-made policy will apply to injuries that occur before its inception date, provided the claim is first made against the insured during the policy period. For such claims, the coverage will be on an excess basis if prior policies also apply. These coverage features, together with an inherent price advantage over the occurrence contract, should make the claims-made policy an attractive alternative in the marketplace.

I fully appreciate that some insurers and producers are not totally enamored with every aspect of this ISO program with two separate versions of the contract. But we believe this approach is right, and it's in keeping with the view that product differentiation will separate the winners from the losers in the years ahead. In order to insure the program's smooth implementation in the marketplace, ISO will, over the next two years, conduct comprehensive education and training programs for insurers and producers throughout the country.

Our business environment also dictates cost efficiency and, here again, ISO has been responsive. During 1983, ISO reduced its work force 9% by restructuring our field operations—without diminishing our essential services to insurers and producers. This work-force reduction will result in a $9 million annual saving to participating insurers. In 1983, ISO operated at $5.2 million or 3.5% below budget, as we continued to demand increased productivity and aggressively pursued our "sunset-reprioritization" program. "Sunset-reprioritization" simply means that *all* ISO products and services are constantly reviewed to determine if they're still essential to our participating insurers. If they are—fine. If not, we kill them.

In fact, our 1983 expenses were less than in 1982. Our 1984 budget is 1% below last year's expenses and projects ISO's lowest level of spending since 1979. ISO's excellent fiscal performance could not have been achieved without the dedication, loyalty, hard work and understanding of our professional staff. For that, I am most grateful.

Efficiency through automation is the theme of another major development at ISO—the delivery of ISO products and services via telecommunications. Our second wholly-owned subsidiary, ISO Telecommunications, Inc., or ISOTEL, was formed on October 1, 1983.

* * *

ISO frequently has commented on the deteriorating results for the Commercial Lines of insurance, specifically noting the marked differences between ISO advisory rate changes and industry premium changes over the last several years. Unfortunately, 1983 was no different. In meeting our number one corporate objective of adequate advisory rates, ISO achieved a countrywide average advisory increase of 8% for the Commercial Lines of insurance, while industry premiums remained essentially flat.

Ultimately, the pricing practices of insurers have the greatest impact on their overall financial results. Those results—and our analysis of those results—sadly indicate that the overall financial strength of our business is being relentlessly weakened by the brutal battle for commercial market share.

There are many who say that excess capacity is the cause of this competition. Policyholders' surplus is perhaps the best measure of this capacity, and it is a fact that surplus has been growing over the last several years. The industry ratio of written premium to surplus, which reached a high of 2.7 to 1 in 1974, stood at 1.7 to 1 at the end of 1982 and is estimated to be 1.6 to 1 for 1983. But surplus figures are reliable only to the extent the underlying estimates of assets and liabilities are sound.

I will not dwell on the assets side of the picture today. You all are aware of the buoyant effect on

Exhibit B

APPENDIX III

surplus of carrying bonds at amortized rather than market value.

On the liabilities side, we are looking at essentially two entries—the unearned premium reserve and the loss and loss expense reserve. The unearned premium reserve is the one that can be estimated with a high degree of accuracy. But it was more than twenty years ago that this entry was the major liability. It has diminished over the years and is now only a third the size of loss and loss expense reserves.

So today I'll concentrate on loss and loss expense reserves—supplementing the earlier observations of our retiring Board Chairman. The risk of loss reserve deficiency is critical, as it directly reduces surplus.

We've studied the aggregate loss reserves of the 200 companies that write over 90% of the business and make up A.M. Best Company's Casualty Loss Reserve Development Report. Our studies reveal very disquieting patterns. We've examined the development of paid losses by accident year for the five Schedule P lines that represent 90% of all loss reserves. These lines of insurance comprise general liability; multi-peril, including homeowners; automobile liability; workers compensation; and medical malpractice. Based on our analyses, we conclude that the industry's total loss and loss expense reserves, as of December 31, 1982, are inadequate by more than 10%. The results, of course, vary by line of insurance and, even more importantly, by individual insurer. I would like to advise you of the conclusions for two major ISO Commercial Lines. Multi-peril loss reserves, from our studies, are deficient by more than 10%, and general liability loss reserves are deficient by more than 20%.

The industry ratio of loss reserves to policyholders' surplus, at the end of 1982, stood at 1.9 to 1. A 10% understatement of loss reserves translates to a pre-tax 20% overstatement of policyholders' surplus. A correction for this reserve deficiency would increase the industry's loss reserve to surplus ratio to 2.5 to 1, which would be an all-time high. The 1982 premium to surplus ratio would increase from 1.7 to 2.1.

The industry's complete financial results for 1983 aren't yet available. But the results for the first three quarters of 1983 show no strengthening of loss reserves. In fact, the industry's loss reserves increased in that period at an annual rate of only 8 percent, continuing the slowdown in the rate of increase that we've seen in recent years. That 8 percent annual rate of increase would be the lowest rate of increase in loss reserves in 20 years.

It is bad enough that a reserve inadequacy can misstate the financial picture at any given time. Regrettably, reserve inadequacy can also have an adverse prospective impact on pricing. Individual company pricing decisions may be biased downward, and even ISO advisory rates may be understated for a period of time.

The industry's financial position looks even worse, when you consider current and prospective commercial lines underwriting results. For all commercial lines of insurance, we estimate the combined ratio to be at least 115 for 1983, and we see no improvement in 1984. For three key ISO lines, the results, to say the least, will be very poor.

For General Liability, the combined ratio was 116 in 1981 and 129 in 1982. We estimate 137 for 1983 and forecast the same level in 1984. Given an industry combined ratio of 137, assuming reasonable payout patterns and an investment yield of 8.5%, insurers will lose 4 cents on every dollar of General Liability premium that they write this year. That is after investment gains but before taxes. This 4% negative rate of return can only come out of policyholders' surplus.

For Commercial Automobile, the combined ratio was 112 in 1981 and 119 in 1982. We estimate 120 for 1983 and forecast no improvement in 1984. If the industry continues to write at this composite ratio of 120, it will lose 6 cents on every dollar of Commercial Automobile premium written in 1984—again after investment gains but before taxes.

Let's look at Commercial Multi-Peril. The combined ratio was 107 in 1981, 116 in 1982, and we estimate 120 for 1983. If there is any improvement in 1984, it will be slight. If the industry continues to write at this combined ratio of 120, it will lose 6 cents for every dollar of Commercial Multi-Peril premium written in 1984—again based on reasonable assumptions of payout patterns, investment yield, and ignoring tax implications.

For each of these three major Commercial Lines, we are forecasting a negative rate of return in 1984. These 3 lines represent 40% of the total commercial premium volume and must lead to a drain on policyholders' surplus. This drain will aggravate the significant drain on surplus that will occur when the inadequacy of present reserves becomes painfully evident over the next few years.

Facts are stubborn things which, at times, do not make for happiness and contentment. Popular opinion to the contrary, the fundamentals of our insurance business have not really changed over the years; only the specifics of managing the fundamentals have changed with changes in internal and external conditions. Now is the time for insurers to stabilize their commercial lines underwriting operations. It is always better to create a sense of urgency rather than react to a state of crisis. In the long run, no insurer can survive if it does not recover the costs of providing its products or services. The winning insurers will bring their commercial premiums into better sync with their underlying loss costs because, regardless of short term market share objectives, prices have to be determined by costs in the long run. Cost containment will not suffice. Acting on price may involve internal controversy, setbacks and sacrifices, but we should act with the knowledge that history helps those who help themselves.

The next three years will be traumatic for some insurers. The recent early, encouraging signs of recovery—which I hope will be sustained—may be too late for some of these insurers. It's very clear that for those companies that persist in doing business as if there were no tomorrow, there will in fact be none. And all insurers are, by statute, put in the position of ultimately having to "pick up the tab" for those companies' lack of prudence. In this new commercial insurance environment, such a "bail out" program, financed under state guaranty funds by intense competitors, makes little sense, on any score, to me.

These funds were created as a small solution to what was then a small problem. Neither supporters nor opponents of these funds ever said that this mechanism could cope effectively with insolvencies of large, multi-line insurers or of medium-sized companies writing high exposure specialty coverages such as medical malpractice and products liability.

Post-assessment guaranty funds exist today in virtually all states and cover virtually all lines of property/casualty insurance. States originally created these funds—with the support of a large segment of the industry—in response to a national concern for the policyholders and claimants of the many borderline, non-standard automobile insurance writers which became insolvent during the late 1950's and 60's. Proponents of the funds believed that the overall problem was minor, that insolvency detection by state insurance departments was improving, that such funds would be inexpensive to operate, that assessments under the funds would be a small price to pay to avoid further damage to the industry's already tarnished public image, and, finally, that the existence of the funds would avoid imposition of an unwanted and overreaching solution by the federal government.

From 1969 through 1983, guaranty funds serviced eighty-two relatively small insolvencies, with a total projected gross cost to insurers of some $400 million. But each time a potential major insolvency has loomed on the horizon, the inadequacies of the post-assessment fund mechanisms have become apparent. Solutions have been achieved through the infusion of fresh capital, takeovers by outside interests and voluntary, insurer-supported rehabilitation efforts. The

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funds were not the solution. The recent Baldwin-United situation once again highlights the inadequacy of the current guaranty fund system to handle impairments of major magnitude.

And when confronted with a major insolvency, the tax-offset method of recoupment will prove unacceptable to the public. Tax revenues would be diminished at the very time state governments are struggling to meet their own budget deficits.

Today, when aggressive competition in commercial lines is testing even the best insurer managements, when profit margins are slimmer than ever before, and when profitable cash flow underwriting is easier to achieve in concept than in execution, I believe it is time to reevaluate the fundamentals of a system which requires solvent and well-managed insurers to contribute their funds to bail out the policyholders of insolvent, poorly managed insurers.

The costly coverage provided by the current guaranty fund system is illustrated dramatically by the inclusion of medical malpractice insurance. ISO's review of Schedule P loss reserves indicates that the industry in the aggregate was under-reserved, at the end of 1982, by at least 50% for medical malpractice insurance. Over 50% of this insurance is written by relatively new companies providing coverage for their owners at rates considerably lower than those charged by conventional insurers of this business. By the nature of this "long tail" line of insurance, the claims experience will be excellent for the first few years, and then steadily deteriorate. If insolvencies result, the economic burden of those insolvencies will be borne by the conventional market—those same insurers whose higher rates were undercut in the first instance. And the individuals protected will be those very same individuals who were responsible for the underpricing.

Post-assessment funds were created to protect policyholders of "high risk" auto insurers, a class of insurance consumers with few options and the least ability to protect themselves. But today, these funds cover virtually all types of property/casualty insurance and, consequently, also extend protection to the most sophisticated and financially solid insurance purchasers. And the funds even provide coverage for the owner-insureds of specialty companies.

A fundamental reexamination of the "scope of coverage" is overdue. A number of questions need to be debated, namely:

What lines of insurance are appropriate?

Why are commercial lines included?

Should coverage be restricted to personal lines?

Should per claim limits be lowered and deductibles raised?

Should unearned premiums be covered?

Should coverage be limited to economic loss only?

The guaranty fund situation presents substantive challenges to both our industry and government. The continued vitality of state regulation will ultimately depend upon how it deals with solvency regulation in this new insurance/financial environment. While not an ISO responsibility, I believe that our industry has a golden opportunity to step back and reexamine these state guaranty funds. I trust we will neither shirk from this challenge nor miss this opportunity.

The next few years will test all of us in the property-liability insurance business. But we've been tested before and, as before, I know our industry will show the clear thinking, adroit management, and resolute leadership that will see us through this difficult period and permit us to share, with other industries, in the profitable growth period ahead for all business.

I would like to conclude with another tribute to the ISO staff—professionals all. Their competence, dedication and effort are gratefully acknowledged. I am, personally, most appreciative of their efforts.

Thank you for the privilege of serving you again as President last year.

ANALYSIS OF Loss Reserves

for the Property-Casualty Insurance Industry

The attached exhibits present an analysis of the adequacy of industry loss and loss adjustment expense reserves as of December 31, 1982 for three Schedule P lines. The data underlying the analysis are from A. M. Best Company's Casualty Loss Reserve Development Reports which aggregate Schedule P information for selected companies representing over 90% of the industry.

The method used traces movements in accident year paid losses for several evaluations. Based on these historical developments of paid losses, factors are developed and applied to the December 31, 1982 evaluation of paid losses in order to estimate the needed reserve levels.

The method assumes that:

(1) Payout patterns remain consistent over time. This assumption appears reasonable given the stable link ratios that are shown for each line of insurance.

(2) Reserves for accident years 1978 and prior are correct.

The following results are obtained:

Line of Insurance	Estimated Reserve Deficiency
General Liability	−24.3%
Medical Malpractice	−79.4%
Multiple Peril	−13.3%

The reserve deficiency for the three lines studied represents 10.7% of total industry reserves.

The methodology employed, as well as the conclusions reached, are conservative. The methodology was applied to industry aggregates and may not be appropriate for analyzing individual insurers, because:

- the underlying assumptions may not apply to individual insurers
- large individual claims may distort the results for any single insurer
- the product mix of individual insurers varies from that of the industry as a whole

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Loss Reserve Analysis
General Liability
Paid Loss Development

LOSS & LOSS EXPENSE PAYMENTS AT END OF:*

Accident Year	12 Months	24 Months	36 Months	48 Months	60 Months
1976	256526	544312	850612	1209420	1568894
1977	272338	587316	936638	1363421	1768970
1978	306069	679052	1096918	1591600	2035703
1979	361960	804011	1299744	1879163	—
1980	395391	925635	1534532	—	—
1981	435638	1042795	—	—	—
1982	562661	—	—	—	—

PAID LOSS DEVELOPMENT LINK RATIOS

Accident Year	12-24 Months	24-36 Months	36-48 Months	48-60 Months	60 Months-Ultimate**
1976				1.297	1.749
1977			1.456	1.297	1.698
1978		1.615	1.451	1.279	1.664
1979	2.221	1.617	1.446		
1980	2.341	1.658			
1981	2.394				
Average	2.319	1.630	1.451	1.291	1.704

PAID LOSS DEVELOPMENT FACTORS

48 Months to **Ultimate 2.200**
36 Months to **Ultimate 3.192**
24 Months to **Ultimate 5.203**
12 Months to **Ultimate 12.066**

* SOURCE A.M. Best's Casualty Loss Reserve Development Report (000's omitted)
** Based on Reported Ultimate Losses ÷ Paid Losses as of 60 months

Loss Reserve Analysis
General Liability
Paid Loss Development

Accident Year	(1) Paid Losses as of 12/31/82	(2) Paid Loss Development Factor	(3) Estimated Ultimate Incurred Losses (1)×(2)	(4) Estimated Reserve (3)−(1)	(5) Reported Reserve	(6) Difference (5)−(4)	(7) Total Reported Reserves as of 12/31/82***	(8) Estimated Reserve Deficiency (6)÷(7)
1979	1879163	2.200	4134159	2254996	2003899	−251097		
1980	1534532	3.192	4898226	3363694	2712539	−651155		
1981	1042795	5.203	5425662	4382867	3401203	−981664		
1982	562661	12.066	6789068	6226407	4048106	−2178301		
					TOTAL	−4062217	16716030	−24.3%

*** Includes reserves for years 1978 and prior which are assumed to be correct

APPENDIX III

Loss Reserve Analysis
Medical Malpractice
Paid Loss Development

LOSS & LOSS EXPENSE PAYMENTS AT END OF:*

Accident Year	12 Months	24 Months	36 Months	48 Months	60 Months
1976	8796	31651	73168	137207	222815
1977	15426	44111	99576	182063	284607
1978	19565	61052	132961	248760	377301
1979	23943	77912	180873	329792	—
1980	29892	109380	251727	—	—
1981	37465	146439	—	—	—
1982	57600	—	—	—	—

PAID LOSS DEVELOPMENT LINK RATIOS

Accident Year	12-24 Months	24-36 Months	36-48 Months	48-60 Months	60 Months-Ultimate**
1976				1.624	2.878
1977			1.828	1.563	2.552
1978		2.178	1.871	1.517	2.315
1979	3.254	2.322	1.823	Average 1.568	Average 2.582
1980	3.659	2.301	Average 1.841		
1981	3.909	Average 2.267			
	Average 3.607				

PAID LOSS DEVELOPMENT FACTORS

48 Months to **Ultimate 4.049**
36 Months to **Ultimate 7.453**
24 Months to **Ultimate 16.897**
12 Months to **Ultimate 60.947**

* SOURCE: A.M. Best's Casualty Loss Reserve Development Report (excludes one company) (000's omitted).
** Based on Reported Ultimate Losses – Paid Losses as of 60 months.

Loss Reserve Analysis
Medical Malpractice
Paid Loss Development

Accident Year	(1) Paid Losses as of 12/31/82	(2) Paid Loss Development Factor	(3) Estimated Ultimate Incurred Losses (1)×(2)	(4) Estimated Reserve (3)−(1)	(5) Reported Reserve	(6) Difference (5)−(4)	(7) Total Reported Reserves as of 12/31/82***	(8) Estimated Reserve Deficiency (6)÷(7)
1979	329792	4.049	1335328	1005536	678300	−327236		
1980	251727	7.453	1876121	1624394	891836	−732558		
1981	146439	16.897	2474380	2327941	1117583	−1210358		
1982	57600	60.947	3510547	3452947	1394166	−2058781		
					TOTAL	−4328933.	5451677	−79.4%

** Includes reserves for years 1978 and prior which are assumed to be correct

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Loss Reserve Analysis
Multiple Peril
Paid Loss Development

LOSS & LOSS EXPENSE PAYMENTS AT END OF:*

Accident Year	12 Months	24 Months	36 Months	48 Months	60 Months
1976	3455774	4949539	5312797	5555371	5732975
1977	3785076	5538276	5929702	6197334	6413127
1978	4373176	6332792	6823695	7143211	7404407
1979	5784426	8266583	8834612	9243059	—
1980	6819461	9816262	10470791	—	—
1981	7076682	10014783	—	—	—
1982	8612280	—	—	—	—

PAID LOSS DEVELOPMENT LINK RATIOS

Accident Year	12-24 Months	24-36 Months	36-48 Months	48-60 Months	60 Months-Ultimate**
1976				1.032	1.064
1977			1.045	1.035	1.065
1978		1.078	1.047	1.037	1.062
1979	1.429	1.069	1.046	Average 1.035	Average 1.064
1980	1.439	1.067	Average 1.046		
1981	1.415	Average 1.071			
	Average 1.428				

PAID LOSS DEVELOPMENT FACTORS

48 Months to **Ultimate 1.101**
36 Months to **Ultimate 1.152**
24 Months to **Ultimate 1.234**
12 Months to **Ultimate 1.762**

* SOURCE A M Best's Casualty Loss Reserve Development Report (000's omitted)
** Based on Reported Ultimate Losses - Paid Losses as of 60 months

Loss Reserve Analysis
Multiple Peril
Paid Loss Development

Accident Year	(1) Paid Losses as of 12/31/82	(2) Paid Loss Development Factor	(3) Estimated Ultimate Incurred Losses (1)×(2)	(4) Estimated Reserve (3)−(1)	(5) Reported Reserve	(6) Difference (5)−(4)	(7) Total Reported Reserves as of 12/31/82***	(8) Estimated Reserve Deficiency (6)÷(7)
1979	9243059	1.101	10176608	933549	814396	−119153		
1980	10470791	1.152	12062351	1591560	1287941	−303619		
1981	10014783	1.234	12358242	2343459	2110013	−233446		
1982	8612280	1.762	15174837	6562557	5749686	−812871		
					TOTAL	−1469089	11087116	−13.3%

*** Includes reserves for years 1978 and prior which are assumed to be correct

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ANALYSIS OF
Pre-Tax Rates of Return
for the
Property-Casualty Insurance Industry

The attached exhibits develop the pre-tax rate of return reflecting investment income for General Liability, Commercial Multiple Peril and Commercial Automobile. The model assumptions are best presented by explaining the numbered columns in the attached exhibits.

Column (1)—Years (From Policy Inception):

The model tracks both income and outgo generated by a single policy beginning at policy inception and continuing until the final loss payment is made. The model assumes that all payments (other than dividends) are made at year end.

Column (2)—Premium Collection:

The model assumes that the entire premium is available for investment by the insurer at policy inception.

Column (3)—Expense & Dividend Payment:

Expenses other than loss adjustment expenses are assumed paid at policy inception. The assumptions on premium collection and expense payment are consistent. Dividends are assumed to be paid 6 months after policy expiration. The column (3) total represents A. M. Best's estimate of the 1983 expense and dividend ratios.

Column (4)—Loss & Loss Adjustment Expense Payment Pattern:

The loss and loss adjustment expense payment patterns are based on studies of the industry's payment pattern for each of the lines of business. The total is the assumed loss and loss adjustment expense ratio for the line.

Column (5)—Net Payment Pattern:

This column represents the net income and outflow to the insurer in nominal dollars. The total is the assumed combined ratio for the line.

Column (6)—Discount Factor:

This factor is applied to discount the value of the eventual income and outflow and evaluate the net flow at policy inception. It is assumed that all available monies are invested at 8.5% per annum.

Column (7)—Discounted Payment Pattern:

The total of this column represents the rate of return reflecting investment income.

The rate-of-return model can be applied to individual insurers, based on their expected payout pattern, their expected combined ratios and their expected investment yield. The model's results are on a pre-tax basis, and tax implications for individual insurers can vary significantly.

Operating Results After Investment Income
General Liability

(1)	(2)	(3)	(4)	(5)	(6)	(7)
Years (From Policy Inception)	Premium Collection	Expense & Dividend Payment	Loss & LAE Payment Pattern	Net Payment Pattern (2)−(3)−(4)	Discount Factor 1÷(1.085)†	Discounted Payment Pattern (5)×(6)
0	1.000	.324	.000	.676	1.000	.676
1			.093	- .093	.922	- 086
1.5		.008 z	.000	- .008	.885	- .007
2			.114	- 114	.849	- 097
3			.156	-.156	.783	-.122
4			135	- 135	.722	- 097
5			.125	-.125	.665	-.083
6			104	- 104	.613	-.064
7			.104	-.104	.565	-.059
8			073	-.073	.521	- .038
9			.052	- 052	480	- 025
10			.052	- .052	.442	- .023
11			.030	- .030	.408	- 012
Total	1.000	.332	1.038	- .370		-.037
		Expense & Dividend Ratio	**Loss & LAE Ratio**	**Combined Ratio (=137.0)**	**Rounded Rate of Return Reflecting Investment Income**	**-.04**

z Dividend Payment
† The exponents used in the formula are the numbers of years from policy inception, as listed in column (1).

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Operating Results After Investment Income
Commercial Multiple Peril

(1) Years (From Policy Inception)	(2) Premium Collection	(3) Expense & Dividend Payment	(4) Loss & LAE Payment Pattern	(5) Net Payment Pattern (2)−(3)−(4)	(6) Discount Factor 1÷(1.085)[t]	(7) Discounted Payment Pattern (5)×(6)
0	1.000	.403	.000	.597	1.000	.597
1			.354	−.354	922	−.326
1.5		.008 z	.000	−.008	.885	−.007
2			.191	−.191	.849	−.162
3			.073	−.073	.783	−.057
4			.052	−.052	.722	−.038
5			.039	−.039	.665	−.026
6			.021	−.021	.613	−.013
7			.023	−.023	.565	−.013
8			.018	−.018	.521	−.009
9			.009	−.009	.480	−.004
10			.003	−.003	.442	−.001
11			.006	−.006	.408	−.002
Total	1.000	.411	.789	−.200		−.061
		Expense & Dividend Ratio	**Loss & LAE Ratio**	**Combined Ratio (=120.0)**	**Rounded**	**−.06**
					Rate of Return Reflecting Investment Income	

z Dividend Payment

[t] The exponents used in the formula are the numbers of years from policy inception, as listed in column (1).

Operating Results After Investment Income
Commercial Automobile

(1) Years (From Policy Inception)	(2) Premium Collection	(3) Expense & Dividend Payment	(4) Loss & LAE Payment Pattern	(5) Net Payment Pattern (2)−(3)−(4)	(6) Discount Factor 1÷(1.085)[t]	(7) Discounted Payment Pattern (5)×(6)
0	1.000	.326	.000	.674	1.000	.674
1			.395	−.395	.922	−.364
1.5		.007 z	.000	−.007	.885	−.006
2			.199	−.199	.849	−.169
3			.120	−.120	.783	−.094
4			069	−.069	.722	−.050
5			.044	−.044	.665	−.029
6			.016	−.016	.613	−.010
7			.010	−.010	.565	−.006
8			.004	−.004	.521	−.002
9			.010	−.010	.480	−.005
Total	1.000	.333	.867	−.200		−.061
		Expense & Dividend Ratio	**Loss & LAE Ratio**	**Combined Ratio (=120.0)**	**Rounded**	**−.06**
					Rate of Return Reflecting Investment Income	

z Dividend Payment

[t] The exponents used in the formula are the numbers of years from policy inception, as listed in column (1).

AMERICAN INSURANCE ASSOCIATION

85 John Street
New York, N. Y. 10038
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February 24, 1984

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

As President of the American Insurance Association, I thank you for the opportunity to comment on the draft of a Proposed Report ("draft" or "report") prepared by the Staff of the U.S. General Accounting Office (GAO) entitled "Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry." One hundred seventy casualty insurance companies, predominantly organized as stock companies, are members of the American Insurance Association. In 1982 our member companies accounted for twenty-nine percent of the industry's total premium volume. This letter is in response to your request that we provide comments to assist the Congress in its consideration of your recommendations.

Industry Agreement

We have reviewed the comments on the draft made by the National Association of Independent Insurers, the Alliance of American Insurers, the National Association of

WILLIAM O. BAILEY, CHAIRMAN PETER LARDNER, VICE CHAIRMAN EDWARD H. BUDD, VICE CHAIRMAN T. LAWRENCE JONES, PRESIDENT

Mutual Insurance Companies and the Reinsurance Association of America. As we agree with the views expressed by such comments, we endorse those comments and commend them to you for consideration.

GAO Recommendations

The GAO draft recommends that the Congress consider changes in the following three areas:

(1) The Congress should consider amending the tax code to provide that, in calculating the loss reserve deduction for tax purposes, loss reserves should be discounted. The discount rate should be based on a moving average of each company's pre-tax net return on its investment portfolio;

(2) The Congress should consider amending the tax code to provide that acquisition costs should be allocated over the life of related contracts; and

(3) The Congress should consider whether continuation of the protection against loss account is warranted.

The report recognizes that "the property and casualty insurance industry is an important part of the American economy" (dr. Digest, p.i). Casualty insurance companies serve the public interest by providing protection against the risk of financial loss to both businesses and individuals. The industry operates under a regulatory

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system governing its investments, marketing and solvency which has provided a high degree of reliability to policyholders and injured parties.

The American Insurance Association and its member companies are prepared to assist in the review of the taxation of casualty insurance companies, and our comments on the draft are intended to continue the dialogue on that subject. For the reasons noted below, we conclude that the draft is fundamentally flawed and cannot serve as the basis for legislation. We believe the draft's proposals require substantial additional study and consideration given their far-reaching impact and the complexities inherent in the subject matter.

The GAO Draft Does Not Justify Its Recommendation That Loss Reserves Should Be Discounted

We seriously dispute the draft's conclusion that loss reserves should be discounted. The basic premise of the draft that leads to such conclusion is that there is a mismatching of revenue and expenses. The draft's premise that mismatching exists is incorrect and is based on an example (Tables 3 and 4) constructed on unrealistic assumptions calculated to establish the desired conclusion. These assumptions oversimplify the operation of casualty insurance companies to such a degree that the

Page	Line	
3 thru 4	19 2	The premise of mismatching is not based on the examples (tables 3 and 4 of the report). The examples were developed to illustrate the premise, and in our opinion they do illustrate this point. The response to comment 4, page 35 of the report explains why such things as loading for expenses were omitted from the examples. It further states that introducing such things would not have changed the outcome which the examples were meant to show: The present undiscounted reserve deduction results in a profit being realized from an otherwise profitless transaction.

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example does not provide any basis for legislative change.

The draft contains several conclusory statements that mismatching exists, but the draft's only attempt to support this conclusion is by a comparison of the results in its Tables 3 and 4. These tables compare the alternative economic and tax consequences of a specific assumed factual situation using discounted and undiscounted loss reserves. They lend a surface plausibility to the conclusion that there is mismatching and are superficially appealing, but on close consideration it is clear that they have been constructed on totally unrealistic assumptions, which are not representative of actual conditions, for the apparent purpose of proving that mismatching exists. As the tables are the sole justification for the draft's conclusion on mismatching, the assumptions underlying such tables merit close scrutiny.

Two critical assumptions were made in constructing the tables (dr. p. 16): (1) "a loss payment of $1,000 will have to be paid 5 years later;" (emphasis added) and (2) the premium and all earnings retained and reinvested will provide a 10 percent return, compounded semi-annually.

As a theoretical concept, discounting may be appropriate where definite payments are to be made at

4 3-18 The examples were based on clearly stated assumptions and were unrealistic only to the extent they ignored expenses and were based on premiums lower than companies would probably be willing to charge. The tables are only for the purpose of illustrating the point and are not the sole justification for the conclusion that mismatching exists. The mismatching occurs because the amount of deduction taken under the undiscounted reserve deduction method is not allocated over the period of deferral, whereas the offsetting premium income is allocated.

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specific points in time, and we submit that such conclusion is all that the example provided by Tables 3 and 4 illustrates. But the assumption of a fixed and definite payment ($1,000) at a specific point in time (in 5 years) is far removed from the realities of establishing loss reserves of casualty insurance companies.

The establishment of casualty company loss reserves is a complex and difficult process -- one that is full of uncertainties. The ultimate loss may be zero or $2,000 rather than $1,000. The loss payment may be made immediately or in one or two years rather than in five. These obvious uncertainties exist but are assumed away by the tables.

In fact, if the ultimate loss should turn out to be $1,000 and if the $1,000 were paid in five years as projected, recent past history indicates that the loss reserve established would have been only $910 rather than $1,000. This will be substantiated by the discussion below on the industry's lack of success in recent years in fully measuring the extent of the industry's losses.

The second critical assumption of the tables is that one can project the rate of future earnings. Certainly the varying rates of return enjoyed by investors in recent years are indicative of the uncertainties inherent in such projections. The draft acknowledges that its investment

5 3-13 The use of a specific point in time (5 years) as the expected time of payment is used for illustration. We do not agree that it "is far removed from the realities of establishing loss reserves of casualty insurance companies." As the comment states, property casualty companies in their rate-making of necessity must use expected payment patterns. The period used represents a single case selected as an example of many cases with different payout patterns. Other examples representing payouts in 2, 3, or 4 years might also have been used to make the same point as the examples we used. In light of the above, we do not feel that any uncertainties are assumed away by the tables. We do recognize that there can be uncertainty about the time of payment of any individual claim, although in the aggregate it is possible (and necessary for rate-making purposes) to determine an average period of payment deferral.

5 14-20 The $910 reserve mentioned in this paragraph apparently refers to a 10 percent underreserving as previously referred to in the report of the President of Insurance Services Offices, Inc. It can be shown that if table 4 had used this amount as a reserve deduction instead of the full amount of $1,000, the comparison of the two examples would not have been greatly different. The results of the discounted reserve deduction in table 3 would have been a profitless transaction, while table 4, using $910 instead of $1000 as a first year reserve deduction, would have shown cumulative profit.

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6 8 With regard to discount rates the draft did state that future interest rates are not known with certainty. It did not state that the assumption was not realistic. The 5-year moving average of an individual company was suggested as a pratical mechanism that could approximate the company's future earnings rate. It also stated that the use of a 5-year moving average would with the passage of time tend to be self correcting.

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assumption is not realistic and that earnings and interest rates cannot be known with any certainty (dr. p. 20). In fact, the draft recommends the use of a moving average of current and prior investment returns as a discount rate for the very reason that earnings rates do fluctuate sharply (dr. p. 21). This does not cure the unrealities of the assumption and at best will ameliorate its effect in some limited situations.

This 10% rate of return also assumes that all of the premium will be available for investment and that it will be available immediately. This, of course, is not what happens. A company's receipt of premiums often is delayed. Even after premiums are received, some must be used for purposes other than investment. The example altogether ignores the existence of any expenses.

The three assumptions -- the certainty of the amount of the eventual payment, the time it will be paid, and the ability to project future earnings accurately -- are critical to the draft's conclusions. Because these assumptions are so removed from the realities of the complex and uncertain process of establishing loss reserves, any conclusion derived from the example is suspect and not relevant to the question of whether loss reserves should be discounted for tax purposes.

6 9-15 As previously mentioned, for illustrative purposes expenses were not included in the examples. This, however, does not mean that the use of an assumed rate of 10 percent in the examples was incorrect. Expenses could have been reflected both in the premium charged and in the annual deductions from taxable income, and the two examples would still have illustrated the point that they were designed to show. Admittedly, this would have made for a more realistic example, but the final result would have been the same: without discounting, the profitless transaction becomes profitable. See response to comment number 4.

6 16-24 See the last four responses immediately above.

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Almost every other assumption made in constructing the tables also is subject to question. The use of a $613.00 premium and a $1,000 anticipated loss provides a dramatic example of apparent mismatching. But as dramatic as that difference seems to be, this relationship of an assumed premium ($613) and a projected loss ($1,000) has little resemblance to reality. When looking at aggregate projected losses for the purpose of setting a premium rate, an anticipated loss to premium ratio of 163% (the ratio used in the table) cannot be considered representative even in these difficult times. Setting premiums on the basis of such assumptions would lead to certain disaster. Finally, the tables assume that the company will have income from other sources. Given recent history, this too may be an unwarranted assumption as many casualty insurance companies have been reporting losses in recent years.

Where the assumptions underlying the tables are so different from what actually occurs and where the tables are the sole support for the alleged mismatching, there is no basis for the draft's conclusion that loss reserves should be discounted. The burden of showing that discounted reserves will improve the current system of taxation has not been satisfied. Thus, the draft's

7 1-13 See response to comment number 4.

7 13-17 The profitability of the property/casualty industry has generally been characterized by cycles. The losses reported by some companies for tax purposes over the last few years were the result of a downward cycle. However, according to an industry expert, this downward cycle may be coming to an end. The president of the Insurance Services Office, in a recent address before the Association of Insurance and Financial Analysts in New York City, indicated that the turn in the underwriting cycle has started and that for the long term he is "very bullish on the industry." In any event, the stage of the cycle the industry is in at any point should be irrelevant to the issue of good tax law for the whole cycle.

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8 2 We disagree with the statements in this paragraph. See our response to the comments starting on page 3, line 19 of this source.

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recommendation is fatally flawed and must be reconsidered.

The Recommended Discounting Merely Accelerates the Reporting of Future Income

The mismatching perceived by the draft is the allowance of a current deduction for the amount that a casualty insurance company expects to pay as the result of a loss which has occurred in the current taxable year unreduced by the future investment income to be earned in taxable years subsequent to the one in which the loss occurred.

The draft apparently recognizes that it would be improper to require a casualty insurance company to include future investment income (which the company may or may not actually earn) as part of its current tax base. Nevertheless, it seeks to achieve that same result indirectly by reducing the otherwise allowable current deduction for incurred losses by an amount reflecting the company's expected future investment income.

Under present law a casualty insurance company includes in taxable income all underwriting and investment income it earns as of the end of the taxable year. This method of reporting income is in accordance with the accounting methods approved by the National Association of Insurance Commissioners ("NAIC"), which have served as the

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9 2 This statement does not properly reflect the fact that unearned premiums are not included in taxable income. This is in accordance with accounting methods approved by the National Association of Insurance Commissioners, and in our opinion this is the principal reason why mismatching results. The total amount of any premium is included in income, but any portion of it that is not earned in the current year is added to the unearned premium reserve and therefore gets excluded from that year's income, even though under present NAIC rules a deduction for the full amount of expenses is allowed.

basis for the taxation of casualty insurance companies for more than 60 years.

The special nature of the casualty insurance industry and its obligation to policyholders was noted by the Tax Court in Bituminous Casualty Corp. v. Commissioner, 57 T.C. 58 (1971) at p. 77:

> -- The nature of casualty insurance requires accounting rules substantially different from the accounting rules applicable to general commerce.
>
> In commerce generally, expenses come first and income follows. The manufacturer must incur the cost of manufacturing his product before he gets paid for it. The merchant must purchase his inventory before he can resell it.
>
> In the insurance industry, however, the reverse is true. The policyholder pays the insurance company in advance and the insurance company's costs, which are primarily the payment of claims, come afterwards. If the premiums were to be taxed as received, and the deductions allowed only as they later became fixed, the result would be to tax very large sums of money as income when in fact those amounts will never really become income because they will have to be paid out to policyholders and other claimants. (Emphasis added.)

Granting insurers a deduction for losses incurred is consistent with the fundamental policy of not subjecting to tax amounts received which are subject to substantial restrictions on their use. State insurance laws require companies to establish reserves which are adequate to meet their obligations to policyholders and claimants. They are not available to the company for its unrestricted "use and enjoyment."

9 26 We agree with the basic premise stated in this paragraph. However, we differ with them with respect to the amount to be deducted. The interest earned on reserve funds is available to the company.

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All income (underwriting and investment) is reported for tax purposes as soon as it is not required for policyholders or claimants. The present method of accounting for tax purposes recognizes the special nature of the industry and its obligation to policyholders. It should not be changed merely to correct a perceived mismatching of expenses and revenue.

The Treasury Department Has Rejected Discounting of Future Expenses

In response to a question asked of Assistant Secretary John Chapoton during his testimony before the House Ways and Means Committee on February 22, 1984, Secretary Chapoton explained that the Treasury Department had studied discounting of future expenses but found that it was "a thicket which you will never get out of." His written statement makes it clear that the complexity and inaccuracy of any discounting formula would make it impossible to administer:

> Our proposal has been criticized for failing to match properly the future expense with the current income that gives rise to that expense. Those who express this criticism argue that future expenses should be deductible at discounted values over the period of economic activity giving rise to the expenses. While allowing a current deduction for the present discounted values of future expenses clearly is proper from the perspective of creditors and others who utilize financial statements, various practical considerations preclude implementing such a rule for income tax purposes.

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11 20 The testimony of Assistant Secretary of the Treasury referred to in this section did not address insurance company taxation. It was specifically directed to the overstatement of deductions by accrual method taxpayers who in certain cases can currently deduct expenses that will not be paid for many years. For Treasury's position on taxation of property/casualty insurance industry in general and reserve discounting in particular, see Treasury comments printed at the beginning of this appendix.

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> As an administrative matter, determining the present discounted values for all kinds of future expenses would introduce unmanageable uncertainty and undesirable complexity. Discount rates could not be determined individually for each business. Rather, certain economy-wide average discount rates would have to be employed. These discount rates would have to be applied to mere estimates of the amount of the expenses to be incurred at estimated dates in the future. Any discounted expenses therefore would represent only an estimate of future expenses, and that estimate would be wrong in every case in which either the amount of the future expenses or the time for economic performance was estimated incorrectly. A system that allowed current deductions for discounted future expenses would have to include a complex set of recomputation rules for recalculating overstated and understated deductions when the future liabilities were actually satisfied at a time or in an amount different from that originally projected.

The introduction of "unmanageable uncertainty and undesirable complexities" referred to by the Treasury Department's statement on the discounting of <u>future</u> expenses applies with greater force to the discounting of <u>current</u> loss reserve liabilities of casualty insurance companies. Although the GAO report incorrectly refers to such liabilities as "future expenses" (dr. pp. 14-15), they are estimates of payments to be made on losses that already have occurred. There is no justification for the adoption of a complex formula to determine loss reserves for federal income tax purposes. Adoption of discounting in this area would be certain to produce even greater administrative burdens for both the government and taxpayers than those which now exist.

11 21-26 We do not agree that any possible complexities in the discounting of future expenses apply with greater force to discounting current loss reserve liabilities of casualty insurance companies. Property casualty insurance, by its very nature, is based on managing uncertainty, and the handling of complexities is inherent in the background of casualty insurance rate-making and management.

11 27-29 This matter has been corrected in the final draft. See p. 12 where the term "future expenses" has been changed to "future loss payments".

11 31-34 The question to be decided here is whether any additional administrative expense is justified by additional tax revenue. This issue is beyond the scope of this report although it is a factor that the Congress could consider before making any changes.

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Prior Consideration by Others Has Not Led to a Recommendation For Discounted Loss Reserves

There is no regulatory requirement that loss reserves of casualty insurance companies be discounted. The propriety of such discounting has been the subject of study and consideration by both regulatory and accounting groups. The National Association of Insurance Commissioners, The American Institute of Certified Public Accountants, and The American Academy of Actuaries all have given substantial time in considering the propriety of discounting. None of these regulatory or professional bodies has recommended the adoption of discounted loss reserves.

The draft relies on the Statement of Financial Accounting Standards 60, *Accounting and Reporting by Insurance Enterprises*, issued by the Financial Accounting Standards Board ("FASB") on June, 1982 to support its determination that "matching" of expenses and revenues is an appropriate measure of annual income and yet ignores that organization's failure to recommend the discounting of loss reserves.

The accounting groups considering this issue have a special concern for the proper matching of revenues and expenses for financial reporting to investors. They have not recommended the practice of discounting loss reserves

12 3-13 The fact that various regulatory bodies and others have not recommended the adoption of discounting is in our opinion not conclusive since these organizations are not directly concerned with the establishment of tax policy. However, it is our understanding that the recent NAIC report on investment income does effectively discount reserves. (See Report of the Investment Task Force to the NAIC, June 1984).

12 14-21 FASB 60 permits but does not at this time require discounting of reserves. We have changed the report to eliminate reference to FASB 60, although it is still our position that discounting is not in conflict with that accounting statement. However, since FASB 60 does not apply to the determination of taxable income, we removed all references to FASB 60 from the report.

12 24-25 This statement is true as of the present time but see note above opposite lines 3-13.

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to achieve such matching. Even if discounting were warranted, one or more of such groups should be the first to recommend its use.

The NAIC strenuously opposes discounting of loss reserves for tax purposes. In a letter dated October 17, 1983 to the Honorable Robert Dole, the National Association of Insurance Commissioners expressed its grave concern about the impact of discounting loss reserves for federal tax purposes by noting:

> ...the NAIC is gravely concerned that the proposed changes in the accounting for loss reserves and the accounting for premiums for federal income tax purposes will adversely affect:
>
> o The integrity and credibility of currently prescribed statutory accounting principles,
>
> o The solvency and financial stability of the U.S. property and casualty insurance industry, and
>
> o The timeliness of claim payments by insurers to their policyholders and claimants.

This recognition of the problems inherent in discounting and the potential impact that discounting would have on the industry are policy issues that raise legitimate concerns and should be taken into account in any legislative consideration.

13 1-3 As stated in response to the comment on page 12, lines 3-13, the accounting and other groups named in the comment have no direct concern with tax policy and as such there is no reason to expect that they should be the first to recommend its (discounting) use.

13 4-24 Attached later in this appendix is a letter containing direct comments from the NAIC. We refer the reader to our response to those comments.

At this point we would comment on the question of "timeliness of claim payments" mentioned on lines 18 and 19. We are unable to see how the proposal for discounting would adversely affect the timeliness of claim payments since the faster a claim is paid the larger the current deduction. If anything it should be an incentive to speed up claim payments.

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The Uncertainties Inherent in Establishing Loss Reserves Distinguish Them From Financing Arrangements and Life Insurance Reserves Whose Accuracy May be Improved by Discounting

Adopting a separate measurement of casualty company reserve liabilities unique to the federal tax code would be justified only if it produced an accurate measurement of current loss liabilities. Discounting introduces the substantial additional uncertainty of the timing of loss payments to the already complex process of determining the amount of proper liability estimates.

The method of discounting used by the draft in making its revenue estimates suggests that the pattern of payments should be determined on the basis of historical experience. The timing of payments in prior years will not necessarily provide an appropriate standard for determining the pattern of payments in subsequent years if, for example, payments in the past have been unduly delayed or accelerated.

Departure from a prior payment pattern can occur for many reasons. It can occur upon the adoption of new policy forms (e.g., reflecting a change from occurrence to claims made coverage in malpractice insurance), upon a change in underwriting standards, as well as upon a change in a company's general settlement practices. Payment patterns will vary from one line of business to the next

14 8-11 We do not agree that discounting "introduces the subsantial additional uncertainty of the timing of loss payments to the already complex process of determining the amount of proper liability estimates." The matter of the timing of loss payments must have already been an integral part of not only the reserve development but also the premium calculations.

14 12-26 Discounting does infer that a pattern of payments will be used. We do suggest that the pattern of payments should be determined on the basis of historical experience. The commentator does not agree that this will necessarily provide an appropriate standard for future payments. While past history will not always be reproduced in the future, its use, if updated from year to year, should over time approximate actual experience. We feel that the basis for our suggested use of historical experience is strengthened by its use by recognized experts in the casualty insurance industry. We refer to the study by the President of Insurance Services Office, Inc. which is the principal basis for the industry claim that loss reserves are understated. The pertinent quotation is as follows:

> "The method assumes that: (1) "Payout patterns remain consistent over time. This assumption appears reasonable given stable link ratios that are shown for each line of insurance."

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and even within a single line from one year to another. More significantly, payment patterns will vary substantially from company to company so that an industry average is not a meaningful standard. The consequences of an inaccurate standard for determining payment patterns or discount rates to individual members, to competitive balance, and to the industry as a whole could be dramatic as well as unforeseen.

Where liabilities are fixed and the time of payment is known, there may be some justification for discounting. Discounting is taken into account in determining original issue discount where bonds and other debt obligations are issued at a specified issue price that is less than the stated redemption price at maturity. Under such circumstances, the difference between such known amounts will be taken into income over a specific period of time. But such tax consequences are proper only because all essential elements are certain.

Discounting also is involved in the establishment of life insurance reserves where the essential elements are known or can be predicted with substantial certainty. Life insurance reserves reflect a liability to pay a specified amount in the future. They represent an accumulation of funds to pay that amount. As all insureds will die, the event is certain, and the only uncertainty

15 3-4 We agree with this statement that "an industry average is not a meaningful standard." We would point out, however, that our suggestion was not for an industry average method but for a company by company one. Page 59, Appendix II under (9) Discounted Unpaid Losses reads"---In applying the discount rate to unpaid losses the discounting period and the annual discount factors shall be based on each taxpayer's own historical pattern of loss payments or its estimates of the proportions of current taxable year unpaid losses to be paid in future taxable years." Special rules would likely be needed for small and newly formed companies. This should be handled by IRS regulations.

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16 21 This comment relating differences between life insurance and property/casualty insurance apparently attempts to show that the property/casualty business involves a much greater degree of uncertainty than life insurance and because of this it would be improper to discount p/c loss reserves. It seems to overlook the fact that p/c insurance, as well as life insurance, is largely based on historical statistical experience. This statistical experience is used to estimate all phases of claim experience.

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is the time of death. Even as to this uncertainty, mortality tables have been developed which provide substantial certainty as to the rates of death at various ages. Thus, there is (1) a certainty that payments will be made, (2) a certainty as to the amount of such payments and (3) a substantial certainty as to the time when such payments will be made. Loss reserves of casualty insurance companies differ from such life insurance reserves in that (1) the event that may require the payment of a liability has occurred; (2) the amount of any eventual payment is uncertain and (3) the timing of the payment cannot be accurately forecast.

Where certainty does not exist, discounting may merely reduce an already inadequate tax deduction for existing liabilities rather than reflect the time value of money. This would be the case if the loss reserve liability to be discounted has been underestimated. Because of the uncertainties inherent in the establishment of unpaid loss liabilities, casualty insurance company unpaid loss reserves are the least appropriate place to require discounting to reflect the time value of money.

As a result of the industry's reserve underestimations in recent years the federal government already may have realized a substantial economic benefit. Such benefit may even be comparable to that which it might

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17 2 Our position is that if reserves are inadequate they should be strengthened by the state regulators responsible for such activity and then discounted for tax purposes.

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have realized from any required discounting of more accurate loss reserve estimates over such period.

The Proposed Method for Determining a Discount Rate Will Lead to Distortions

The draft has not established the necessary foundation for its recommendation on discounting because the fundamental premise of mismatching which underlies such recommendation has not been substantiated. Accordingly, we will not comment on the draft's suggested method of implementing such discounting or other details discussed in the draft. Nevertheless, we must point out that the draft's method of determining a discount rate (i.e., a moving average of each company's investment return for the current and preceding 4 years) is totally inappropriate.

From 1976 through 1981, the average annual prime interest rate has ranged from 6.8 percent in 1976 to 18.9 percent in 1981. Other investments experienced similar fluctuations. To discount for the future on the basis of a moving average of past experience will cause serious distortions whenever the future investment return varies in any substantial manner from that of the historical period. Recent fluctuations indicate that this is a real possibility. Furthermore, such a method of determining the discount rate can lead to revised investment practices

17 12-15 We disagree that the draft's method of determining a discount rate is *totally inappropriate.* An identical 5-year moving average has been used in the life insurance tax law for the last 25 years. While there have been questions, principally concerning the assets to be used in the rate's determination, we believe that the use of a 5-year average has never been in question. Nevertheless, the actual period to be used could either be this 5 years or a different period to be established by legislation or regulations.

17 16 We do agree that interest rates can fluctuate. However, the 5-year average suggested is a portfolio rate, and the swings in this rate from year to year are not of the nature suggested by the cited changes in prime rates.

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by the industry and is inconsistent with a tax system that seeks neutrality on such matters.

<u>The Financial Position of the Industry is Deteriorating and its Loss Reserves Have Been Substantially Understated</u>

Although the report recognizes that the industry is an "important part of the American economy," the industry profile fails to convey certain significant characteristics of the industry's operations:

- competition for market share is intense, and the market is not concentrated -- the business is not dominated by a few large firms;
- competition among carriers for market share has been intensified by loss of business to captives and other self-insurance arrangements;
- in recent years, increases in premium levels have been held to a minimum, a development which causes many observers to be concerned not merely for profitability but for the solvency of a number of companies;
- the industry has reached a tenuous moment in its evolution: reliance upon high interest rates to offset underwriting losses -- "cash flow underwriting" -- has permitted underwriting losses to grow so large that observers fear that changes in investment returns may lead to

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23 7 This section of the comments relate to industry profitability and the matter of underreserving. Comment number 1, pages 31-32 of the report covers the matter of underreserving and comment number 3, pages 33-34 of the report, concerns industry profitability. For our overall response the reader is referred to these comments.

18 10-15 The question of competition was considered by us but was felt to be beyond the scope of the report.

18 16-20 A recent interview of the President of Insurance Services Offices, Inc. reported in the May 1984 issue of Coopers and Lybrand <u>Insurance Newsletter</u> included comments on this matter of premium levels. We will quote two statements from the interview on this subject.

1. "Insurers for personal lines have already stabilized and moved their prices upward. Fortunately there are signs that commercial prices are becoming stable."

2. "--but more and more producers say companies are refusing to cut prices below a certain point." In the opinion of this expert, it would appear that a turning point in the low-premium underwriting loss cycle may have been reached.

Even though we have given the above quotations concerning the present position in the cycle, it is our opinion, as pointed out in a previous comment, that the present position in the cycle should be irrelevent to good tax law for the whole cycle.

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substantial operating losses; individual companies have in fact sustained substantial operating losses for 1983. For example, CIGNA has determined that it sustained a $26,000,000 loss in 1983 from its casualty operations taking into account both underwriting and investment returns.

John G. Burridge, a Best's executive, commented in a recent article:

> Those who have assumed that underwriting losses up to a certain point are acceptable because they can be offset by investment income overestimate the ability of management to control the loss ratio so finely as to hold to a given limit...Now the companies are reaching the point where they can see that underwriting losses already have or soon will cut off the flow of money needed to maintain an increase in investment income. The only solution is to stabilize the underwriting operation.

"Review and Preview" by John G. Burridge, Best's Review, January 1984, 28 at p. 30.

A brief review of industry statistics will illustrate the dilemma now facing insurers. Insurers' profitability is measured by underwriting profit or loss and investment gain or loss. In 1982, the industry recorded an underwriting loss of over $8 billion, or 8.1 percent of earned premiums. Estimates by A.M. Best Company, the principal data collection service for the industry, show

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20 2 These statistics for 1982 are incomplete in that they refer only to underwriting losses and do not mention the investment gains. Best's Aggregates and Averages figures show for 1982 that the mutual and stock companies they cover had underwriting losses of about $8 billion, investment gains of about $19 billion, increase in surplus of about $8 billion, dividends paid to stockholders of $3.7 billion, and federal income taxes paid of -$0.6 billion. We feel this gives a more complete picture of the profitability of p/c companies in 1982. Similar figures for 1983 were underwriting losses of about $10.6 billion, investment gains of about $19.7 billion, increase in surplus of about $5.2 billion, dividends paid to stockholders of $3.8 billion, and federal income taxes paid of -$1.1 billion.

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an underwriting loss for 1983 of $12.2 billion on a premium volume of $108.44 billion.

The draft acknowledges that the casualty insurance industry had become less profitable since 1977. It points out that net premiums written between 1977-82 increased by about 47 percent, but total income (net investment and underwriting gains or losses) decreased by about one-third (before taxes). (dr. p. 6)

A 1981 report comparing insurers' rate of return to that of 85 other industries showed that over a 15 year period (1966-1980) the casualty insurance industry's average rate of return was lower than average returns for the median non-insurance industry. In addition, insurers showed lower annual returns in 11 of the 15 years. Table 2 (dr. p. 7) reflects that the trend continued in 1982 when the casualty insurance industry's 8.9 percent rate of return as a percentage of net worth was only 81 percent of the 11.0 percent rate of return reflected by the next lowest industry (manufacturing).

The deteriorating financial picture of the casualty insurance industry may be even more serious than the above statistics indicate because it also appears that the liabilities of the industry for incurred losses have been understated in recent years. Such underreserving is indicative of the difficulties inherent in the process of

20 thru 21 9-25 22 See our response to comment 3 of report for discussion of industry profitability.

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establishing appropriate reserves and is especially prevalent with respect to long-tail lines. Generally, loss estimates on long-tail lines have been short because of events that could not be foreseen at the time the reserves were established.

For example, in the mid-seventies, the industry experienced dramatic shifts in expenses as the economy went from high inflation to price controls, and then saw dramatic "protective" price increases following the end of price controls. Projections of health care costs, the rate of inflation and other economic factors considered in ratemaking and reserving could not be taken into account rapidly enough to follow the shifts in economic trends. While reserve deficiencies in long-tail lines such as medical malpractice and workers' compensation were pronounced, even short-tail lines such as automobile physical damage and bodily injury, which require projections of repair and health care costs, were hard-hit by difficulties in projecting trends.

More recent evidence of continued underreserving is found in the remarks of Daniel J. McNamara, President of the Insurance Services Office, Inc. ("ISO") made on January 10, 1984 at the Thirteenth Annual Meeting of the ISO wherein he stated:

> We've studied the aggregate loss reserves of the 200 companies that write over 90% of the business and make up A.M. Best Company's Casualty Loss Reserve Development Report. Our studies reveal very disquieting patterns. We've examined the development of paid losses by accident year for the five Schedule P lines that represent 90% of all loss reserves. These lines of insurance comprise general liability; multi-peril, including homeowners; automobile liability; workers compensation; and medical malpractice. Based on our analyses, <u>we conclude that the industry's total loss and loss expense reserves, as of December 31, 1982, are inadequate by more than 10%</u>.
>
> * * *
>
> The industry's complete financial results for 1983 aren't yet available. But the results for the first three quarters of 1983 show no strengthening of loss reserves. In fact, the industry's loss reserves increased in that period at an annual rate of only 8 percent, continuing the slowdown in the rate of increase that we've seen in recent years. That 8 percent annual rate of increase would be the lowest rate of increase in loss reserves in 20 years.
>
> * * *
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> The industry's financial position looks even worse, when you consider current and prospective commercial lines underwriting results. For all commercial lines of insurance, <u>we estimate the combined ratio [the ratio of losses and expenses to premiums] to be at least 115 for 1983, and we see no improvement in 1984</u>. (Emphasis added.)

The NAIC letter to Senator Dole expressed its concern as to the impact that discounting loss reserves for tax purposes would have on this serious problem when it stated that: "[a]ny change in the accounting for loss reserves will encourage further under-reserving."

Recommendations which lead to the imposition of additional tax liabilities on an industry which has

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experienced a declining profit picture, that has a lower rate of return on net worth than other industries and that has substantially underestimated its present liabilities appear to be misguided policy even if such recommendations are based on theoretically correct premises. Where, as in the instant case, they are based on invalid assumptions, they are totally unwarranted.

Economic Effects on the Industry and its Customers Also Must Be Considered Prior to Recommending Legislation Which Mandates Discounting

No major legislative change should be adopted without consideration of the potential impact of discounting on the present competitive balance of the various types of companies in the casualty insurance industry, on the competitive balance between the industry and self-insurers and captive insurance companies, on the potential loss of insurance business to foreign insurers, on the increased cost of insurance to consumers (with the consequent revenue loss resulting from the increase in deductible premiums for business insurance), and on the extent it would influence investment decisions by the industry. Any recommendation for a revision of the current statute can be made only after extensive studies have been completed on at least the matters described above and on the operations and economics of the industry in general.

23 5-7 We disagree with the statement that invalid assumptions have been used in the report.

23 12 We found no evidence that our suggestions for possible changes in tax policy would affect the competitive balance of the various types of companies in the p/c industry. None of the comments we have received from industry sources have said that discounting would affect competitive balance between say, stock and mutual companies, self insurers and insurers, etc.

23 17 See response to comment 7, p. 38 of report.

23 18 We were not able to evaluate the increased cost of insurance to consumers because of lack of concrete knowledge as to the degree of "pass-on" of higher taxes in premiums, etc.

23 21 We recognized that there could be changes in investment decisions and included a disclaimer in the report since it is impossible to estimate beforehand the extent of such investment changes.

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Revenue Estimates

The draft's revenue estimate reflecting the proposed discounting of loss reserves appears to be substantially overstated. The draft's revenue estimate does not take into account that casualty insurance companies must pass on the burden of any tax increase to policyholders. To the extent that increased premiums will be required on business insurance, such premiums will be deductible for tax purposes and will reduce the taxes otherwise collected from such policyholders. Assuming these policyholders will be subject to an effective tax rate that exceeds that of the financially troubled casualty companies, there will be a loss of revenue. Thus, the true revenue impact of discounting may be substantially less than projected even if all the draft's assumptions in making such estimate are correct.

Allocation of Acquisition Expenses

The draft states that the current deduction of certain expenses which it labels "acquisition" expenses presents a second area of mismatching of revenue and expense. The expenses so labelled include expenses related to "receiving and paying premiums and commissions, collecting premiums from agents and insureds, reconciling records relating to premiums, compiling expiration lists and notices due, and paying commissions and allowances to

24 4-6 See response to comment 5, pages 35-36 of report. The report was changed on page 19 to include a reference to this.

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28 7 The draft report definitions of "acquisition" expenses have been narrowed in the final draft so as to cover only those expenses about which there should be little cause for disagreement. Regulations would be needed to specify the actual items to be included.

Mr. William J. Anderson
February 24, 1984
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agents, brokers, and employees" (dr. p. 26). Although not mentioned in the text of the draft, the legislative language proposed by the draft also includes "advertising" as part of this category (dr. p. II-5). In this respect, contrast the draft's proposal with the Internal Revenue Service's present position in Treas. Regs. §1.471-11(c)(2)(ii) and Rev. Rul. 68-561, 1968-2, C.B. 117.

The illustration of mismatching in this second area of recommended change assumes the issuance of a 3-year policy for which an insurance company receives premiums in advance. Such premiums are included in current income only as earned. The draft concludes that "if the matching principle is to operate correctly, expenses must be treated the same way" (dr. p. 27).

Although the text of the draft appears to be concerned only with multi-year policies, the revenue estimate indicates that the recommendation encompasses "acquisition" costs of one-year contracts where the policy year falls within two taxable periods.

The recommendation that acquisition expenses be capitalized and amortized over the life of the contract is contrary to the general principle of tax accounting that an expenditure need not be capitalized where its benefit does not extend "substantially beyond" the close of the

25 9-15 The example on page 22 of the report has been changed from a 3-year policy to a 1 year policy to remove any cause for misunderstanding that our suggested tax changes were based on multi-year contracts, which no longer are the norm.

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26 9 Our position is to achieve closer matching even if the contract is only for 1 year or less. Premiums paid for a period beyond the end of the year of issue are allocated as earned and unearned, and we feel the same treatment should be used for acquisition expenses. This would involve changes in existing regulations as well as legislation. We do not feel that under our suggestion there would be any problem of tracking expenses, since once a particular expense is identified as being acquisition, it is allocated solely on the ratio of total earned to total premiums.

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taxable year in which it is paid or accrued. Treas. Regs. §1.461-1(a).

Under current tax accounting principles, amortization of acquisition expenses over the life of a one-year policy would not be justified. Substantial administrative expenses would be required in tracking and allocating acquisition costs over two taxable years and this would result in only a slight shift in expenses which over time would not have any substantial effect on revenues.

Moreover, the draft report's recommendation is inconsistent with the Treasury Department's determination when it reviewed this issue. In testimony before the Senate Finance Committee on June 13, 1983, Assistant Secretary John Chapoton stated:

> Treasury does not believe that it is necessary to revise this long-standing practice at the present time.

If the industry's long-standing practice does constitute mismatching, it is mismatching for one year at most and is comparable to that allowed other taxpayers where payments received are to be included in income as earned. (See for example, the deduction allowed for circulation expenditures under Section 173 coupled with the deferral of prepaid subscriptions as income pursuant to Section 455.)

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Mr. William J. Anderson
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We are concerned that in the effort to present a case for mismatching, the draft report presents an example which is inaccurate and misleading. As an example of the mismatching which might occur, the report assumes the issuance of a three-year contract. Quite simply, three year policies are not common within the insurance industry. One-year policies are the norm, and in lines which are experiencing pricing problems, policies often are issued for only six month periods. A review of the draft's Table 4 in Appendix I (dr. p. I-10) indicates that almost all of the revenue estimate on this recommendation is attributable to one-year policies.

To the extent that "acquisition" costs remain level, the amount of annual deductions allowed under the draft proposal will be the same as those allowed under the current system. By deferring the tax deduction of "acquisition" costs (which in almost every case will be for only one year), this recommendation will adversely affect only those insurance companies with increasing "acquisition" costs and therefore a lesser tax deduction under the GAO recommendation than presently allowed. Such increase in acquisition costs may occur because a company's business is growing. In times of high inflation, it also may occur solely because of inflation. Under such circumstances, any additional tax revenue

27 5-9 See response to comment 5, pages 35-36 of report.

27 18-20 We agree with this statement, but according to studies made by Best's, most companies are growing both as to premium income and amount of insurance coverage. However, it should be pointed out that growth and additional tax revenue, if any, because of inflation is not unique to the property/casualty industry.

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generated by this recommendation would be attributable to such inflation.

This recommendation would change a long-standing practice, which is not unique to the casualty insurance industry, to achieve a theoretical purity not considered necessary by the Treasury Department. Its adoption is not justified.

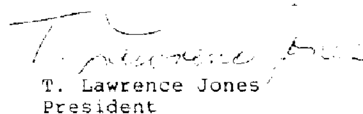
Protection Against Loss Account

Mutual companies cannot look to shareholders for capital that may be required to maintain or increase their capacity for writing insurance. To alleviate this problem Congress provided the PAL account whereby the tax on certain amounts can be deferred and thereby retained as part of the surplus of such companies. Nothing in the draft indicates that the PAL account has not served its intended purpose or that it will not continue to do so in the future. In the context of present law the draft's conclusion on this matter is questionable.

Further Assistance Available

We appreciate the opportunity you have given us to comment upon the draft and we will be pleased to discuss our comments with you or your representatives.

Sincerely yours,



T. Lawrence Jones
President

28 8-18 See response to comment 9, page 42-43 of report.

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APPENDIX III

THE HOME INSURANCE COMPANY

MICHAEL J. NEVENS
ASSISTANT VICE PRESIDENT

February 22, 1984

Mr. Natwar M. Gandhi
Senior Evaluator
Program Analysis Division
United States General Accounting Office
General Government Division
Washington, D. C. 20548

Dear Mr. Gandhi:

We enclose a statement of our comments on the draft of a proposed report entitled "Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry" which was prepared by the staff of the United States General Accounting Office. For your convenience two additional copies of the statement are enclosed.

This statement is submitted on behalf of the following property/casualty insurance companies:

American International Group
Chubb & Son, Inc.
CNA Insurance Companies
The Continental Corporation
The Home Insurance Company

Very truly yours,

Michael Nevens
Assistant Vice President
The Home Insurance Company

MN:cp
Enc.

Comments on
The Draft of a Proposed Report Entitled
"Congress Should Consider Changing
Federal Income Taxation of the
Property/Casualty Insurance Industry"
Prepared by the Staff of the
United States General Accounting Office

In its draft of a proposed report entitled "Congress Should Consider Changing Federal Income Taxation of the Property/ Casualty Insurance Industry," the Staff of the U.S. General Accounting Office has suggested that Congress give consideration to three changes in the manner in which property and casualty ("P&C") insurers are taxed under the Internal Revenue Code. One of those suggestions, and the only one to which these comments are addressed, is the proposal that Congress enact a requirement that P&C insurers discount their unpaid losses for federal income tax purposes. The omission of any discussion of the other two proposals, which deal with acquisition expenses and the PAL account, is not intended and should not be interpreted to imply agreement with the suggestions made in the Draft Report.

These comments are not intended as a comprehensive critique of that portion of the Draft Report dealing with unpaid losses. They are limited to a discussion of two central points. First, the case for discounting the unpaid losses of P&C insurers made in the Draft Report rests upon a fundamentally erroneous understanding of the pricing

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2 1 See response to comment number 4, page 35 of report.

APPENDIX III

mechanism of P&C insurance. Second, the Draft Report fails to take into account the serious inadequacies in the existing unpaid losses of P&C insurers and, as a result, ignores the devastating impact of applying a discounting requirement to estimates which understate the ultimate loss payments.

2 1-6 See response to comment number 1, page 32 of report.

The Draft Report Is Based on a Misunderstanding of the Mechanism by Which P&C Insurance Is Priced

In an attempt to justify a discounting requirement, the Draft Report sets forth, at pages 15 through 17, what purports to be a simplified, but realistic, hypothetical example of a P&C insurance transaction. The example begins with the assumed fact that the P&C insurer issues a six-month policy for which the premium is received on June 30, 1980, and it assumes, for the sake of simplicity, that the insurer incurs no expenses in connection with the transaction.

The example then assumes that (1) "the premium is set to equal the discounted value of the loss payment," (2) the P&C insurer will have to pay a loss of $1000, (3) the loss will be paid on June 30, 1985, (4) the premium will be invested at a 10 percent interest rate, compounded semiannually, (5) all of the P&C insurer's earnings will be reinvested at the same 10 percent rate, and (6) the P&C

APPENDIX III

insurer has other income against which it can offset any negative tax liability arising from the transaction. On the basis of these assumptions, the example concludes that the P&C insurer will charge a premium of $613.91.

However, the first assumption is false, and the remaining assumptions are simply unrealistic. The falsity of the first assumption becomes readily apparent if one additional assumption is made: the P&C insurer had a policyholders surplus at January 1, 1980 of $500, an amount certainly sufficient to support premium writings of $613.91. At December 31, 1980, policyholders surplus would be reduced to $195.86 ($500 plus investment income of $51.25 plus premiums of $613.91 plus investment income of $30.70 less unpaid losses of $1,000). If the insurer were to renew the policy for another six months on December 30, 1980, it would be insolvent for regulatory purposes on or before June 30, 1981. Its policyholders surplus of $195.86 would be increased by the renewal premium of $613.91, and by investment income of $90.49, but would be decreased by the new unpaid loss of $1,000). Barring infusions of additional capital, the P&C insurer would be placed in liquidation by state regulatory authorities.

It is, therefore, obvious that P&C insurance cannot be and is not priced in the manner assumed in the Draft Report. A discussion of the actual process employed by P&C insurers to determine the amount to be charged as premiums, i.e., rating, appears in the written statement submitted to the Senate Committee on Finance with Mr. William F. Gleason,

3 5-22 This assumption that "the premium is set to equal the discounted value of the loss payment" is not false. It was, however, used for illustrative purposes only, knowing that a higher premium, reflecting expenses and profit, would have produced the same result, even though different numerical figures would be shown.

The examples starting on page 13 of chapter 2 of our report were of single transctions or policies. This was done to simplify the examples and to more readily illustrate the point of the different results between discounted and undiscounted loss reserves. However, in actual practice, there would be many policies and transactions involved; some policies would result in early claims, others would not.

The commentator is correct that a company, with a single policy and the quoted amount of surplus, could not remain solvent, particularly if it were to continue with this policy for another 6-month period and experience another claim. It is not clear to us what the actual impact of this example is meant to be. It is clear that a company's surplus is meant to cover all of its policies, and as we said some become claims and many do not. The insurance principle could not operate if it was assumed that every policy would result in a certain claim.

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4 18 See response to comment number 4, page 34 of report. The pricing mechanism used in the examples was for illustrative purposes only and does not invalidate the case for discounting. An example showing actual pricing approaches and real data would show comparable results.

Jr.'s letter of June 24, 1983. A copy of that statement was delivered to Mr. Natwar M. Gandhi, Senior Evaluator, Program Analysis Division, U. S. General Accounting Office.

Accordingly, in lieu of a reiteration of the details of rating, it would seem sufficient to note that under the assumptions made in the Draft Report or under any variation thereof in which the premiums charged by the P&C insurer were less than the amount of the P&C insurer's losses and expenses, no P&C insurer could ever report an underwriting profit. However, some P&C insurers consistently report underwriting profits, and the P&C industry as a whole cyclically reports underwriting profits. The assumptions of the Draft Report cannot be reconciled with these well-documented facts, and it follows, therefore, that those assumptions are erroneous. Since the case for discounting in the Draft Report rests upon a fundamental misconception of the pricing mechanism for P&C insurance, it also follows that the case for discounting must fail.

The Draft Report Fails To Take Into Account the Devastating Impact of Discounting the P&C Industry's Already Inadequate Estimates of Unpaid Losses

In order to determine the present value of a future payment, one must know, among other things, the amount of the future payment and the date upon which it will be paid.

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As noted above, the example set forth on pages 15 through 17 of the Draft Report resolves these two issues by simply assuming that in the year the loss occurs, the P&C insurer knows both the amount and date of payment.

These assumptions are simply unrealistic. A P&C insurer pays its losses in a continuous stream on dates which it cannot foresee either when it writes its policies or when it estimates the amount which it will have to pay on a loss which has occurred but has not yet been settled. As of the date of the occurrence of the loss, the amount that the P&C insurer will be required to pay is similarly uncertain. In the case of losses which remain outstanding over a period of time, the estimate of the amount that will have to be paid to resolve the claim will be reviewed at regular intervals and will, in light of the facts known at the date of review, be increased or decreased accordingly.

Although the example on pages 15 through 17 of the Draft Report employs the unrealistic assumptions that the P&C insurer knows as of the date it fixes the premium the amount and date of payment of the loss, the Draft Report acknowledges elsewhere, in imprecise terms, that P&C insurers do not know the amounts of ultimate loss payments that will have to be paid on existing unpaid losses. Draft Report, p. vii. The Draft Report uses the phrase "the amounts needed to pay future claims" instead of the correct "the amounts needed to pay currently outstanding losses."

5 3-4 We disagree that the draft report, in effect, oversimplifies the matter of determining the amount of loss and the date of payment. While we deal with a single transaction in our example, it is only representative of a large number of similar transactions. In the aggregate the law of large numbers results in a high degree of predictability of the amount and date of loss and the date of payment of the loss. For small and newly formed companies special arrangements, covered by IRS regulations, could be made.

5 24-27 This has been corrected in the final draft, see page 12 of report.

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The Draft Report contends, however, that the fact that unpaid losses represent estimates rather than fixed amounts does not represent an obstacle to discounting unpaid losses, even though a discounting requirement referenced to current estimates would not yield the present value of the future payments. The Draft Report argues that "the uncertainty associated with the reserve estimation process exists whether or not the reserves are discounted" and that "reserve estimates are made annually, and any errors in one year can be corrected in a subsequent year." Draft Report, p. vii.

For any P&C insurer which has underestimated the amounts which it would ultimately be required to pay, the impact of a discounting requirement would be to limit the deduction for unpaid losses to an amount less than the theoretical present value of those losses. If the underestimation were sufficiently severe, then a discounting requirement would be punitive.

It is well recognized that the P&C Industry's estimates of unpaid losses are seriously deficient. Mr. Daniel J. McNamara, President of Insurance Services Office, Inc., ("ISO"), discussed the inadequacy of those estimates in the course of his remarks on January 10, 1984 before the Thirteenth Annual Meeting of ISO. The functions of ISO include the collection and analysis of data relating to the P&C Industry. A photocopy of Mr. McNamara's remarks is attached hereto.

Mr. McNamara stated that ISO had analyzed the aggregate

6 12-18 Comment number 1, pages 31-32 of the report, discusses the matter of underestimation of loss reserves. We agree with the statement in lines 12 through 16, but feel that the remedy for this is to have companies correct their underestimations before discounting.

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loss reserves at December 31, 1982 of the 200 P&C insurers which wrote 90 percent of the business written by all P&C insurers and had concluded that the P&C Industry's total loss and expense reserves at the end of 1982 were inadequate by more than 10 percent. Thus, if a discounting requirement had been imposed for the year 1982, its impact would have been to magnify the inadequacy rather than to reduce the future payments to an assumed present value.

Looking to the future, Mr. McNamara indicated that ISO, using reasonable payout patterns and discounting unpaid losses at an assumed 8.5 percent investment yield, has calculated that for 1984 the P&C Industry will have negative pre-tax rates of return ranging from 4 to 6 percent on three major commercial lines of business, i.e., general liability, commercial auto, and commercial multi-peril, over the period required to pay the losses. If a requirement that unpaid losses be discounted for federal income tax purposes were to be added to this dire scenario, the results would obviously be catastrophic.

The Draft Report's contention that the impact of discounting inadequate estimates in one year would be corrected in a subsequent year ignores the fact that the tax imposed as the result of discounting inadequate estimates may not be recoverable when the correction occurs. In that event the payment of the tax would simply serve to reduce the funds needed to pay losses.

7 20-26 The question of recoverability resulting from adjusting for earlier inadequate estimates does not seem to be different in the case of discounting reserves than undiscounting. Recoveries in either event would be limited only by carryback and carryover provisions.

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Washington, D.C. 20036
(202) 775-9141
TWX 710-822-9270

February 24, 1984

BY HAND

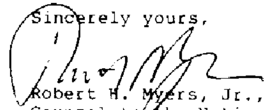
Dr. Natwar Gandhi
U.S. General Accounting Office
1201 E Street, N.W.
Room 606
Washington, D.C. 20223

Re: NAIC Comments to GAO Draft Report: "Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry"

Dear Dr. Gandhi:

Enclosed are the comments of the National Association of Insurance Commissioners (NAIC) to the U.S. General Accounting Office draft report entitled "Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry." It is respectfully requested that these comments be carefully reviewed and taken into consideration in the formulation of the final report. It is also requested that they be published with that report.

Sincerely yours,



Robert H. Myers, Jr.,
Counsel to the National Association of Insurance Commissioners

RHM,Jr./sjw
Enclosure (6 copies)
cc: The Honorable Bill Gunter, President, NAIC
The Honorable Bruce Bunner

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STATE OF CALIFORNIA GEORGE DEUKMEJIAN, Governor

DEPARTMENT OF INSURANCE
600 SOUTH COMMONWEALTH AVENUE
LOS ANGELES, CALIFORNIA 90005

February 23, 1984

Mr. William J. Anderson, Director
General Government Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Anderson:

As Chairman of the National Association of Insurance Commissioners (NAIC) Property and Casualty Taxation Task Force, we present in the paragraphs which follow our collective comments relating to our review of the Draft of a Proposed Report entitled "Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry" prepared by the staff of the U. S. General Accounting Office (GAO).

The GAO is proposing three major tax law changes: (1) the discounting of loss reserves; (2) the amortization of policy acquisition costs over related policy terms; and (3) the elimination of the protection against loss (PAL) account.

The PAL account is a tax concept applicable solely to mutual insurers and unrelated to statutory accounting and thus not a significant concern to the NAIC. We expect the insurance industry will address its concerns with respect to this GAO proposal.

The NAIC is principally concerned with the above mentioned changes relating to the accounting for loss reserves and the accounting for policy acquisition expenses. These proposals, if adopted into law, will, in our opinion adversely affect the efficacy of state regulation insofar as it relates to insurer solvency issues and the preservation of traditional statutory accounting objectives.

1 24-27 We do not agree, see response to comment number 6.

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Mr. William J. Anderson,
Director, General Government Division
United States General Accounting Office
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The GAO appears to overlook either intentionally or unintentionally the fiduciary character of the insurance industry. The GAO comment on page 12 of the draft proposal that states "there is no inherent conflict posed to protection of the public interest by adopting an alternative method of income measurement solely for purposes of taxation," is most disappointing and distressing to the NAIC.

The GAO uses the criteria of Financial Accounting Standard No. 60 (FASB No. 60) Accounting and Reporting by Insurance Enterprises dated June 1982 to support its argument that the statutory accounting of the NAIC is an improper accounting model to measure taxable income because statutory accounting does not match expenses with associated revenues.

The difference between FASB No. 60 and statutory accounting is not as divergent as the GAO would have us believe. Premiums, losses, loss adjusting expenses, maintenance and operating expenses associated with the underwriting function of insurers, and investment income and expenses under both statutory accounting and FASB No. 60 (which conforms to generally accepted accounting principles) are in fact properly matched. Moreover, to the issue of discounting of loss reserves, neither the American Institute of Certified Public Accountants nor the Financial Accounting Standards Board (in its FASB No. 60 pronouncement) have officially adopted accounting principles [illegible] reserves that are dissimilar to those prescribed by the NAIC.

Although statutory accounting is based on solvency concerns, most statutory adjustments are balance sheet oriented and adjusted largely through valuation adjustments (as non-admitted assets) directly to policyholder surplus. The principal deviation of statutory accounting from FASB No. 60 that affects statutory net income and thus, proposed taxable income are policy acquisition expenses. Again the GAO would have us believe that premiums are largely written for periods in excess of one year. This is the exception not the rule. Premiums are written largely for periods of one year or less and the trend is very definitely toward periods of less than one year.

2 2-6 See comment number 6. This statement was deleted from the final draft since it seemed to lead to misunderstanding on the part of more than one commentator, and in any event, the position it expressed was adequately made elsewhere in the report.

2 7-23 See our response to comment of the Associations, p. 3 line 14.

2 30-33 We do not believe that premiums are largely written for periods in excess of 1 year. See response to comment number 5.

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Mr. William J. Anderson,
Director, General Government Division
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Page 3

If fiduciary and public interest objectives are relevant to the insurance industry, then the NAIC would strongly urge that the use of conservative accounting principles in the determination of both statutory and taxable income should be preserved. As for the deferral and amortization of acquisition expenses, why abandon sound statutory accounting practices at the risk of weakening public interest objectives and solvency concerns of the insurance industry solely to achieve the pro-ration of acquisition expenses over short periods of one year or less. Perhaps the GAO proposal, if adopted, more appropriately should relate to such expenses only when contractual premiums are billed and collected for periods in excess of one year.

The proposed tax changes of the GAO trend in the least conservative direction. The erosion of conservative accounting practices does not, in our opinion, serve the public interest. The proposed Life Insurance Tax Act (S 1992) changes also are indicative of such adverse trends. For example, the proposed life insurance tax changes abandon net level reserving for the less conservative CRVM reserving method, require the least conservative mortality and morbidity assumptions for reserving purposes, and incorporate disincentives to economic growth for small life insurance companies (which are not so small) as defined in the proposed legislation. The GAO proposals for property and casualty insurers similarly trends in the least conservative direction. Discounting of loss reserves and the deferral of policy acquisition costs are unrealized income sources, the recognition of which obscures the financial health of the insurer for solvency purposes.

We believe it is fair to conclude that significant tax accounting concepts adopted into law ultimately evolve into generally accepted accounting practices. Likewise, statutory accounting will not be an exception and thus, will evolve in the same direction. The proposed tax measures will be a radical change that will overturn a long standing "partnership" between state insurance regulation and federal tax laws applicable to property and casualty insurance companies.

3 4-9 Our suggestion is that allocation of acquisition expenses be based on the ratio of unearned premiums to premiums written. Premiums, both unearned and written, will be for contracts of all lengths, including those of 1 year or less, as well as those for longer periods. We do not suggest that sound accounting principles be abandoned. Again, we would stress that our concern is with the matching of revenue and expenses for tax purposes, with no consideration of changing any statutory accounting principles felt to be necessary to ensure solvency.

3 13-27 See response to comment number 6, page 37 of report. We disagree with this comment since it is our position that tax and solvency accounting methods serve separate and distinct purposes.

3 28-34 The statement starting on line 28 is a matter of opinion and is certainly not true in all instances. See page ii of the Digest where we limit the scope of the report to measuring income for proposes of federal income taxation only.

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Mr. William J. Anderson,
Director, General Government Division
United States General Accounting Office
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Page 4

The accounting concepts articulated by Financial Accounting Standard No. 60 is not a panacea to solving tax revenue problems of the property and casualty insurance companies. Again, the questionable tax results of the proposal hardly merit the abandonment of sound statutory accounting practices as a basis for the determination of taxable income for this industry. The proposed tax changes do not adequately provide for satisfactory long term income tax revenue objectives. The expected tax revenues are illusory and, to the exent tax revenues are realized, they will be substantially realized only in the transition taxation year or during the phase-in period. The proposed changes simply accelerate the accumulated timing differences existing between the current statutory practices and the proposed tax accounting methods.

The NAIC believes that there are better taxation alternatives if "reform" is truly the rationale as purported by the draft GAO report. Further, the NAIC believes that these alternatives can be formulated and implemented without placing the state regulation of insurance at risk.

Other specific comments and observations relating to the proposed tax measures insofar as they affect statutory accounting, solvency and stability of the industry, and the interests of the consumer are presented below.

Discounting of Loss Reserves

Recognition of the discounted value of aggregate loss reserves for tax purposes anticipates future income. Thus, a tax will be imposed on unrealized investment income that will immediately diminish policyholders' surplus in the amount of the tax imposed. Moreover, the tax imposed could reduce policyholders' surplus by 5% or more, assuming an effective tax rate of 50% and a discount factor of 5%. This results from the size of the industry's loss reserves to surplus, as explained further in the succeeding item.

4 3-6 In our opinion, statutory accounting is not necessarily appropriate for tax purposes. For many other regulated industries the regulatory accounting scheme is not used for tax purposes.

4 11-13 We disagree with this statement. Discounting of loss reserves and allocation of acquisition expenses will increase tax revenues on an ongoing basis, all other things (investments, pass-on of extra taxes, etc.) remaining the same.

Mr. William J. Anderson,
Director, General Government Division
United States General Accounting Office
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- Any change in the account for loss reserves will encourage further under-reserving. The May 1983 edition of Best's Review estimates that the long tail lines (Schedule P reserves) are already under-reserved by 10%. The Insurance Services Office reported similar findings earlier this year. Should statutory accounting for loss reserves be changed to conform to the proposed tax measures, marginal insurers would suddenly appear financially healthy. Aggregate loss and loss expense reserves of most companies, including the top 10 insurers, exceed 2 to 3 (and sometimes more) times policyholders' surplus. Thus, a discount factor of 5% can have a multiplier effect, increasing policyholders' surplus, 10% to 15% or more, respectively.

- Discounting of property and casualty loss reserves is not analogous to life insurance obligations. Unlike life insurance, where premiums contain a savings element (that is set aside for benefits and claims <u>that will occur in the future</u>) in a future benefit reserve at its present value, the loss reserves of the property and casuaty insurers are for claims <u>already occurred</u> (both reported and unreported).

- This tax measure may encourage anti-consumer behavior by the insurer. Any discount model imposed by legislation could consciously or unconsciously promote claim payments delays by insurers in order to conform actual claim payment patterns to the assumptions of the model.

- State regulation already has legal and accounting problems with nonadmitted foreign based reinsurers. This tax measure may promote further proliferation of novel foreign based reinsurance arrangements designed solely to circumvent both Federal taxes and sound statutory accounting practices. These contracts often minimize the amount, if any, of risk transfer and unfortunately result in the transfer of actual reserve funds to locations outside the supervision or control of state regulation.

5 6&7 See response to comment number 6. We specifically do <u>not</u> advocate this.

5 21-25 See response to comment number 6. We did not propose a model but rather the use of each company's own historical pattern. See page 59, appendix II.

5 27-30 See response to comment number 7.

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Mr. William J. Anderson,
Director, General Government Division
United States General Accounting Office
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Amortization of Policy Acquisition Expenses Over Policy Terms

Acquisition expenses related to premiums are in essence an insurer's selling costs. The principal selling cost, although not always, is agents' commissions. Deferral of selling costs, as proposed by the GAO, is not required of other industries. If symmetry is relevant, proposed Section 811 of the Life Insurance Tax Act (S 1992) does not contemplate deferral of commissions and other selling costs.

Commissions to agents and brokers are typically reported in the agents' and brokers' taxable income when received or when the policy is invoiced to the policyholder. Again, if symmetry is relevant, should the insurer be required to defer such costs?

If selling costs are deferred, the GAO draft report is silent with respect to recoverability issues related to the capitalized costs. Unearned premiums must be sufficient to pay all future losses occurring within their unexpired term and including the recovery of related deferred acquisition expenses. If recoverability from unearned premiums cannot be clearly demonstrated, the GAO formula runs the risk of currently capitalizing future underwriting losses.

The statutory accounting system, as currently sanctioned by the Treasury Department, has worked well for over 50 years in achieving its ultimate goal of assuring that the property and casualty industry can perform as to its promises and obligations to the insurance public. This tax proposal, if enacted in its current form at this time, could do irreparable financial damage to this industry and to its policyholders.

6 3-5 This statement does not recognize the fact that while other industries are not required to defer selling expenses, they also cannot defer recognition of revenues, as property casualty companies can.

6 10-14 The point that seems to be missed in this paragraph is that an agent or broker is usually a cash basis taxpayer, while an insurance company is an accrual basis taxpayer. Symmetry between these two bases is by definition impossible.

6 15-22 We agree that the issue of recoverability of capitalized costs is a concern that requires consideration. However, it is a regulatory issue and should be apart from the determination of taxable income.

6 27-29 We disagree with the statement that our suggested tax proposals could do irreparable financial damage to the p/c industry and its policyholders.

APPENDIX III

APPENDIX III

Mr. William J. Anderson,
Director, General Government Division
United States General Accounting Office
February 23, 1984
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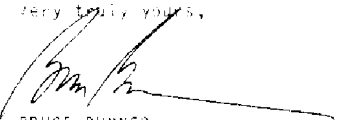
It is the NAIC's desire to assist the Treasury Department in the development of possible tax alternatives that would best achieve sound long-term tax revenue objectives without compromising solvency regulation and the integrity of the current conceptual framework for statutory accounting.

Very truly yours,



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38:mn

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