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Investment Income and Underwriting Profit: "And Never the Twain Shall Meet"?

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INVESTMENT INCOME AND UNDERWRITING PROFIT: "AND NEVER THE TWAIN SHALL MEET"?

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I. INTRODUCTION: THE INVESTMENT-INCOME QUESTION

In writing about the regulation of insurance ratemaking, one need no longer be concerned with the general bases of state regulation of insurance;[1] since 1945, when Congress passed the McCarran-Ferguson Act,[2] state regulation has been accepted as a matter of course. In fact, "after the passage of the McCarran-Ferguson Act, there was pressure from the insurance industry upon the states to occupy the field of insurance regulation more completely, to avoid the threat of federal regulation."[3] This initial ardor has not, however, always resulted in a smoothly functioning hand-in-glove relationship between the insurance industry and the insurance regulators. One notable area of friction has been ratemaking, particularly in relation to the interpretation of the legislative standards governing ratemaking.[4]

These standards usually take the form of a provision that rates shall not be "excessive, inadequate or unfairly discriminatory."[5] Obviously, there is a direct relationship between the "excessiveness" of a given rate and the amount of "profit" that an insurance company derives from premiums based on that rate. The problem is in determining the precise scope of that profit. It is the purpose of this article to

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1 See German Alliance Ins. Co. v. Lewis, 233 U.S. 389 (1914), upholding the constitutionality of insurance rate regulation initiated by Kansas in 1909. For a comprehensive review of the history of state regulation of insurance, see Dean, The Foreign Unauthorized Insurer: A State Regulatory Gap, 32 Ins. Counsel J. 432, 433-36 (1965).

The phrase "ratemaking" is used in a general sense herein to refer to all methods of rate regulation: (1) initial fixing of insurance rates by the state regulator, e.g., Mass. Gen. Laws Ann. ch. 175, § 113B (Supp. 1964); Tex. Ins. Code Ann. arts. 5.01, .25 (1963); (2) review of rates by the state regulator prior to their promulgation, e.g., N.Y. Ins. Law § 184 (McKinney 1966); and (3) review of rates by the state regulator subsequent to promulgation on petition of aggrieved parties, e.g., Cal. Ins. Code § 1858 (West 1955).

2 59 Stat. 33 (1945), 15 U.S.C. §§ 1011-15 (1964).

3 Keeton & O'Connell, Basic Protection for the Traffic Victim—A Blueprint for Reforming Automobile Insurance 524 (1965) [hereinafter cited as Keeton & O'Connell].

4 See id. at 93-97, dealing with the continuous conflict over compulsory motor vehicle insurance rates in Massachusetts.

5 E.g., Cal. Ins. Code § 1852(a) (West 1955).

examine whether investment income of fire and casualty insurers attributable to unearned-premium and loss reserves[6] can and should be reflected in the rates charged policyholders.[7]

If premiums for insurance are paid several years in advance, the premium is considered "earned" only on a yearly basis at most; the excess is considered "unearned" premium. To protect the insured against a lack of funds for reimbursement in the event of cancellation, insurers are required to maintain unearned-premium reserves as a bookkeeping liability countered on the balance sheet by corresponding assets.[8] Such reserves are traditionally of importance in fire insurance underwriting, since prepaid premiums for fire insurance are common. This is not the case for many lines in casualty insurance underwriting (for example, automobile liability insurance), since premiums are rarely paid for periods of more than one year.[9] Claims against casualty insurance are, however, paid far less quickly than fire insurance claims, and loss reserves for the future payment of claims are of greater importance in casualty insurance underwriting.[10] These reserves are similarly countered by assets on the insurer's balance sheet.

Assets representing both unearned-premium and loss reserves are invested, and those investments generate income; the question is whether that income should be considered in the establishment of rates. The "investment-income question" then, in the context chosen for this article, is: When establishing fire and casualty insurance rates, is it "excessive" to allow insurers a percentage of the premium dollar as profit without consideration of the income realized by them due to the investment of monies attributable to reserves?

This question first received judicial cognizance in 1922,[11] and it "continues to reappear."[12] At the present time, the question is the sub-

[6] Since reserves are accounting liabilities and, therefore, the only monies available for investment are the assets corresponding to reserve amounts, the more technical language is "income from the investment of assets held against reserves." See Keeton & O'Connell 94 n.84. For convenience, however, the shorthand phrase "investment income attributable to reserves" will be used, in contrast to investment income attributable to capital accounts.

[7] The investment-income question is relevant only to the capital-stock segment of the insurance industry. Regardless whether such income is or is not considered in ratemaking, mutual insurance companies return all distributed profits, including all investment profits, to their policyholders, who are the owners of the companies as well. See the definition of "mutual insurance company" id. at 583.

[8] E.g., N.Y. Ins. Law § 378 (McKinney 1966). See also Patterson, Essentials of Insurance Law 25 (2d ed. 1957).

[9] Keeton & O'Connell 94 n.84.

[10] For provisions requiring the maintenance of loss reserves by casualty insurers, see, e.g., N.Y. Ins. Law § 326 (McKinney 1966). See also Patterson, op. cit. supra note 8, at 25.

[11] Bullion v. Aetna Ins. Co., 151 Ark. 519, 237 S.W. 716 (1922).

[12] Merrill, Should Investment Income Be Included in Rate-Making, Property &

ject of litigation in the courts of Maryland,[13] and recent administrative ratemaking decisions involving the investment-income question foreshadow further judicial consideration of it.[14] Indeed, the question is of special relevance today because of evolving actuarial theory that would take into consideration not only investment income of fire and casualty insurers attributable to reserves, but other investment income as well.[15]

II. THE "UNDERWRITING-PROFIT" TOTEM

Judicial decisions that have dealt with the investment-income question have thus far been divided in result, and this division has been dependent upon the presence or absence of the adjective "underwriting" in statutory language allowing insurers a reasonable margin for profit in the rates.

In *Bullion v. Aetna Ins. Co.*,[16] a decision that has been given significance in practically all litigation of the investment-income question, the Arkansas Supreme Court had to construe a statute that allowed an "underwriting profit . . . of five pėr cent."[17] The court adopted what it considered to be the "traditional" division of insurance business into underwriting and investment facets, for which it found support in the "1921 Profit Formula for Fire Insurance" of the National Convention (now Association) of Insurance Commissioners. Section two of that formula provided that "no part of the so-called banking profit (or loss) should be considered in arriving at the under-

Casualty Ins. Rev., Sept. 11, 1965, p. 24, slightly revised and reprinted as Investment Income, in Best's Ins. News, Oct. 1965, p. 47 (Fire & Casualty ed.).

13 See notes 33-37 infra and accompanying text.

14 The Kentucky Commissioner of Insurance has recently ruled that increases in automobile liability insurance rates must be offset by investment income attributable to reverses. In the Matter of National Bureau of Casualty Underwriters Proposed Automobile Liability Rate and Rule Revisions for Private Passenger Automobiles (Ky. Dep't of Ins., Feb. 6, 1967). The Texas Board of Insurance, on the other hand, has taken a contrary view. The Board was granted summary judgment in the trial court from which further appeals were not perfected. Brown v. State Board of Ins., No. 145,243-A, Dist. Ct., Travis County, Tex., Jan. 24, 1966; Bader v. State Board of Ins., No. 145,243, Dist. Ct., Travis County, Tex., Oct. 19, 1965. Even so, the ultimate resolution of the question in Texas may not yet have occurred. See Texas Observer, Dec. 30, 1966, pp. 1-4. Unrest over automobile liability insurance rate increases in other states may well bring the question before the insurance regulators and courts of those jurisdictions as well. See, e.g., Boston Globe, Dec. 16, 1966, p. 1, cols. 4-8; id., Dec. 26, 1966, p. 15, cols. 1-8; The Standard, Dec. 9, 1966, p. 10, col. 2; Wall Street Journal, Feb. 13, 1967, p. 1, col. 6.

15 See, e.g., Harwayne, Insurance Risk, Investment and Profits: An Analysis of Monetary Return to Property of Casualty Insurance Companies, Proceedings of National Association of Insurance Commissioners (1966) [hereinafter cited as N.A.I.C. Proceedings]; Leslie, Investment Income and the Profit and Contingency Factor in Rate Making, Proceedings of Conference of Actuaries in Public Practice 82 (1955-56). Unlike the works of Messrs. Harwayne and Leslie, the present discussion is concerned with the "can" as well as the "should" of the investment-income question—but only in relation to reserves.

16 151 Ark. 519, 237 S.W. 716 (1922).

17 Ark. Acts 1919, ch. 163, quoted id. at 521-22, 237 S.W. at 716.

writing profit (or loss)."[18] Proceeding from this, the court went on to accept the view that "insurance circles" did not include as underwriting profit any investment income, whether attributable to reserves or capital accounts, and to adopt this viewpoint as its construction of the Arkansas statute. The result was equated with legislative intent.

The opinion of the Arkansas court in the *Bullion* case was given great weight in the decision of the same question in *Insurance Dep't v. City of Philadelphia*,[19] a case in which an insured rather than the state regulator sought to require consideration of investment income attributable to reserves in fire insurance ratemaking. The Pennsylvania court quoted and adopted the "accepted meaning of 'underwriting profit' " from the *Bullion* decision and specifically rejected the applicability of cases that had allowed consideration of investment income, "because the statutes involved [in those cases] . . . did not contain the term 'underwriting profit.' "[20] A model bill of the National Association of Insurance Commissioners from which the Pennsylvania statute was derived referred only to a reasonable margin for "profit."[21] The Pennsylvania legislature, however, inserted the adjective "underwriting" before the word "profit," which the court construed as an intention to exclude from consideration investment income attributable to reserves.

When the Missouri and Virginia Supreme Courts were faced with the problem of whether or not the state regulator could require that consideration be given to investment income attributable to reserves in determining a reasonable profit for fire insurers, each accepted the division of the insurance industry into underwriting and investment facets, but decided that investment income attributable to reserves constituted profit from the *underwriting* segment of the business. In *Aetna Ins. Co. v. Hyde*,[22] the Missouri Supreme Court, quoting with approval the opinion of the referee in the case, noted that " 'earnings arising from the *investment of underwriting earnings* . . . are the *net fruit* to the insurance companies of their *underwriting activities*.' "[23] The Supreme Court of Appeals of Virginia, in *Aetna Ins. Co. v. Commonwealth*,[24]

18 Report of Fire Insurance Committee, Proceedings of National Convention of Insurance Commissioners 19, 20, 29 (1922). For an analysis of the formula, see McCollough, Reply to Statement of the Committee on Laws, National Board of Fire Underwriters, N.A.I.C. Proceedings 258, 274-80 (1949). See notes 54-58 infra and accompanying text.

19 196 Pa. Super. 221, 173 A.2d 811 (1961), construing the ratemaking provision for fire insurance, which now appears as Pa. Stat. Ann. tit. 40, § 1223(a)(3) (Purdon 1954): "Due consideration shall be given . . . to a reasonable margin for underwriting profit. . . ." See also Pa. Stat. Ann. tit. 40, § 1183(a) (Purdon 1954) for identical language relating to casualty insurance ratemaking.

20 196 Pa. Super. at 250, 173 A.2d at 825.

21 Ibid. But see p. 721 infra for an analysis of that model bill.

22 315 Mo. 113, 285 S.W. 65 (1926), cert. dismissed, 275 U.S. 440 (1927).

23 Id. at 137, 285 S.W. at 73.

24 160 Va. 698, 169 S.E. 859 (1933).

quoted with approval the position of the Virginia Commissioner of Insurance that amplified the rationale of that conclusion:

> [A]ll profits of an insurance company during any given period which are not derived from the investment of its (1) capital, (2) surplus, (3) undivided profits, and (4) borrowed capital must be *profits produced by rates charged.*
>
> [I]ncome from (a) premiums paid by policyholders, and (b) income from the investment of premium income which is being held to meet presently existing but future payable liabilities [*i.e.*, as reserves], are both income produced by rates, and should be included in computing profits produced by rates.[25] (Emphasis added.)

This approach at least intimates that, had the relevant statutes included the "underwriting-profit" totem, as they did not,[26] the decisions would have been the same.[27]

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[25] Id. at 720-21, 169 S.E. at 867.

[26] The statute in Aetna Ins. Co. v. Hyde provided for a "reasonable profit." Mo. Rev. Stat. § 6283 (1919). The same was true of the Virginia statute, which also authorized the regulator "to consider all branches and phases of the business." Va. Acts 1928, ch. 433, § 9.

The present Missouri statute does not contain the "underwriting" adjective and goes even further to require that the Superintendent of Insurance "shall . . . take into consideration . . . all earnings of such companies, *including investment profits.*" Mo. Rev. Stat. § 379.385 (1959). (Emphasis added.) The latter requirement, enacted shortly after the *Hyde* decision, was perhaps a negative reaction to the noninclusion of investment income attributable to capital accounts by Superintendent Hyde.

In Virginia, the statute considered by the court in Aetna Ins. Co. v. Commonwealth was replaced by Va. Acts 1948, ch. 402, which now appears as Va. Code Ann. § 38.1-252(3) (1962). The replacement statute includes the "underwriting profit" language, but the fifteen-year interim between the decision in *Aetna* and the enactment of the new statute indicates that the latter was not a disavowal of the former. The statute was more likely passed in response to the McCarran-Ferguson Act and to the subsequent proposals of the All-Industry Committee of the insurance industry and the National Association of Insurance Commissioners. See Keeton & O'Connell 524. In spite of the "underwriting-profit" language that now governs, and perhaps because of the implications of the opinion in *Aetna*, "an insurance company's income from the investment of assets held against unearned premium reserves are required to be taken into consideration in determining the fire and casualty insurance rates [in Virginia]." Letter from T. Nelson Parker, Virginia Commissioner of Insurance, April 27, 1966. No other forms of investment income are considered. Letter from Commissioner Parker, Nov. 24, 1965.

[27] One other case deserves at least passing mention, though its value as precedent is insubstantial. In Aetna Ins. Co. v. Hyde, 34 F.2d 185 (W.D. Mo. 1929), all of the companies writing fire insurance in Missouri sought to enjoin the enforcement of the rate-reduction order that had been upheld in Aetna Ins. Co. v. Hyde, 315 Mo. 113, 285 S.W. 65 (1926), cert. dismissed, 275 U.S. 440 (1927). The petitions of parties to the prior suit had been dismissed, not for reasons of res judicata, but rather because of their failure to abide by a stipulation conditioned on an adverse result in the Missouri litigation. 34 F.2d at 192. This dismissal was affirmed sub nom. National Fire Ins. Co. v. Thompson, 281 U.S. 331 (1930).

As to those companies who were parties to neither the prior litigation nor the stipulation, the court considered the investment-income question, but not as an attack upon the

The highest court of only one state has gone further than those of Missouri and Virginia. In 1927, the Kansas Supreme Court in *Aetna Ins. Co. v. Travis*[28] rejected the "underwriting-investment" dichotomy of insurance business and allowed the state regulator to require consideration of *all* investment income of fire insurers in determining the rates to be allowed, proceeding under a statute omitting the "underwriting-profit" language.[29] Although that result goes beyond the scope of this article, it is refreshing in its approach to the subject. At a time before the states were coerced into effective regulation of the insurance industry by the McCarran-Ferguson Act,[30] and during a period when other courts were being led by "accepted meanings" in "insurance circles,"[31] the Kansas Court rejected the self-serving conceptualizations of the industry as the basis for determining the legislature's intent as to what was ratemaking in the public interest, the *sine qua non* of insurance regulation. Even so, the case has been "generally rejected elsewhere."[32]

What, then, does this judicial history portend for future cases such as the one now pending in Maryland? Notwithstanding the influence that the underwriting-profit totem has had in the courts and the presence of that totem in the relevant statute,[33] the Maryland Insurance Commissioner has taken the position that investment income attributable to unearned-premium reserves must be considered in the establishment of rates for motor vehicle liability insurance.[34] In rejecting a

Missouri statute nor as a violation of "constitutional guaranties." 34 F.2d at 194-95, 198. The court stated that "the interest on 'unearned' premiums should not be included as underwriting income." Id. at 198. Whether the court's decision of the question was an authoritative holding or at best dictum is open to argument; whatever the characterization, however, the decision is of negligible importance because of its apparent basis on "federal common law." See Erie R.R. v. Tompkins, 304 U.S. 64 (1938).

28 124 Kan. 350, 259 Pac. 1068 (1927), cert. denied sub nom. Aetna Ins. Co. v. Baker, 276 U.S. 628 (1928).

29 Kan. Rev. Stat. § 40-463 (1923), quoted id. at 356, 259 Pac. at 1071. The "underwriting-profit" language has since been introduced into the fire insurance ratemaking provisions by Kan. Acts 1947, ch. 278, § 3. See Kan. Gen. Stat. Ann. § 40-927(a)(3) (1964). As with the subsequent history of the Virginia legislation, note 26 supra, the twenty-year lapse between judicial decision and legislative change probably reflects the spur of the McCarran-Ferguson Act rather than legislative rejection of the court's decision. Contrary to the Virginia experience, however, investment income is no longer considered in ratemaking in Kansas, because the Kansas "statutes would have to be revised before consideration could be given." Letter from Frank Sullivan, Kansas Commissioner of Insurance, Nov. 15, 1965.

30 15 U.S.C. §§ 1011-15 (1964). See notes 3 and 26 supra.

31 Bullion v. Aetna Ins. Co., supra note 11, at 526, 237 S.W. at 718.

32 Insurance Dep't v. City of Philadelphia, 196 Pa. Super. 221, 249, 173 A.2d 811, 825 (1961).

33 Md. Ann. Code art. 48A, § 243(b)(1)(i) (1957).

34 In the matter of National Bureau of Casualty Underwriters' Proposed Revision of Automobile Liability Insurance Rates for Private Passenger Cars and Miscellaneous Classes for the State of Maryland 15 (Maryland Ins. Dep't, Jan. 7, 1966).

request for an increase of approximately twenty-four per cent in motor vehicle liability insurance rates, the Commissioner held that "investment income on the unearned premium reserves is to be considered as a component of underwriting income" in determining the reasonableness and adequacy of those rates.[35] The Commissioner reasoned that "the unearned premium reserve represents funds prepaid by the policyholder in the form of premiums . . . . The income derived from unearned premium reserves would logically . . . be credited to underwriting income for rate making purposes."[36] This determination is clearly in accord with the Missouri and Virginia decisions, which recognized that investment income attributable to reserves was the direct result of underwriting activities and, therefore, allocable to the underwriting facet of insurance business. An appeal from the Commissioner's decision is now pending.[37]

Thus the Maryland courts have been given the opportunity to dispel the notion that one word—"underwriting"—holds the key to

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[35] Ibid.

[36] Id. at 10. Regrettably, the Commissioner rejected in the same opinion similar consideration of investment income attributable to loss reserves. Id. at 9-10. Yet, loss reserves are normally of greater significance in the casualty insurance field. Nevertheless, the Commissioner argued:

> [L]oss reserves are funded out of a company's capital and accumulated surplus and the policyholder . . . should not be entitled to share in any income realized from this source. In other words, since the loss reserves are in effect backed up by the capital and surplus of a company, the one (in this case the stockholder) whose funds are at risk should not be entitled to the fruits thereof.

Ibid. As the last sentence of this quotation makes clear, loss reserves are not "funded" out of capital and surplus in any literal sense. That such reserves are "backed up" by capital and surplus is not denied, but surely to no greater extent than any other reserves and liabilities of the company. Since both unearned-premium and loss reserves are equally attributable to underwriting activities and are, therefore, equally components of underwriting income, the investment income attributable to both unearned-premium and loss reserves should be taken into consideration in ratemaking. As to the fear of incursions on capital and surplus and the attendant risk to shareholders:

> The premiums deposited by policyholders provide, at all times, the entire amount needed for [unearned premium and loss] . . . reserves. With few exceptions, when a company "eats" into its own net worth . . . it is for the purpose of paying in advance for . . . acquisition costs and general expenses . . . . Of course, there are dollars provided in . . . premiums for these purposes, but such dollars are not available . . . until they are earned. Thus, the insurance company must advance such sums [for acquisition costs and general expenses] out of its own net worth until [they] . . . can be recovered from premiums earned.

Leslie, supra note 15, at 86. Hopefully, the position of the Commissioner on investment income attributable to loss reserves will be reconsidered, and the logical extensions of his decision concerning motor vehicle liability insurance ratemaking will be recognized in the ratemaking for fire and other lines of casualty insurance.

[37] In National Bureau of Cas. Underwriters v. Burch, No. 6-69130, Baltimore, Md. City Ct., May 26, 1966, the appeal of the Commissioner's decision was dismissed on the ground that the statutory standard for appellate review was unconstitutional. See Md. Ann. Code art. 48A, § 245(2) (1964). That ruling is being appealed to the Maryland Court of Appeals by the Bureau. Letter from Roger W. Titus, Esq., Assistant City Attorney, Rockville, Md., Feb. 21, 1967.

what is regulation of insurance ratemaking in the public interest. The Maryland statute to be interpreted is identical to the Pennsylvania statute[38] under which consideration of investment income attributable to unearned-premium reserves was rejected in *Insurance Dep't v. City of Philadelphia.*[39] The Maryland courts should not be led to a similar result, however, since the Pennsylvania case was based on definitions of questionable current validity. Rather, the resolution of the investment-income question should be approached from the standpoint of an analysis of the total framework of statutory standards and be guided by the overriding concern that the business of insurance be regulated in the public interest. The following section is an attempt to provide such an analysis—one that will result in a vindication of the Commissioner's determination that investment income attributable to unearned-premium reserves *should* be considered in motor vehicle liability insurance ratemaking and will clear the air of doubts that such consideration *can* be given under fire and casualty ratemaking provisions containing the "underwriting-profit" totem.

III. An Analytic Approach to the Investment-Income Question

Most states require by statute that fire and casualty insurance rates shall not be "excessive, inadequate or unfairly discriminatory."[40] It is to these ambiguous standards that one must direct any relevant argument as to the legality of a given fire or casualty insurance rate. Of particular importance to the investment-income question is the word "excessive," definitions of which are rarely provided by statute.[41] Nor are those definitions that are given of much help. Most preclude a finding of excessiveness unless the "rate is unreasonably high" and there is no "reasonable degree of competition" in the area to which the rate is applicable.[42] Even more circuitous is one definition that provides that a rate is "excessive" only if the companies using the rate have realized profits "in excess of a reasonable amount" over a period comprising the next preceding five years.[43] The result of the ambiguity of these standards has been to leave "to the insurance commissioner

[38] Compare Md. Ann. Code art. 48A, § 243(b)(1)(i) (1957) with Pa. Stat. Ann. tit. 40, § 1223(a)(3) (Purdon 1954).

[39] Supra note 19.

[40] See, e.g., Cal. Ins. Code § 1852(a) (West 1955). The degree of similarity of the various state statutes regarding ratemaking is the result of "the widespread enactment of a number of 'All-Industry' Bills, sponsored by the All-Industry Committee of insurers and by the National Association of Insurance Commissioners." Keeton & O'Connell 524. See, e.g., Fire, Marine and Inland Marine Rate Regulatory Bill, N.A.I.C. Proceedings 410 (1946); Casualty and Surety Rate Regulatory Bill, id. at 397.

[41] Crane, Automobile Insurance Rate Regulation: The Public Control of Price Competition 1 (Ohio State Univ. Bureau of Bus. Research Monograph No. 105, 1962).

[42] See, e.g., Cal. Ins. Code § 1852(a) (West 1955).

[43] S.C. Code Ann. § 37-708 (1962).

[the determination of] . . . the location and amplitude of the zone within which rate levels are proper."[44] Notwithstanding the widespread enactment of the same general standards, "the policy of the insurance departments will vary [from state to state] according to the views and background of the insurance commissioner and according to the traditions or precedents of his office."[45]

The deficiency created by these patently ambiguous standards, however, is at least partially compensated in that the ratemaking statutes contain more specific guides as to what the rate regulator must consider in reaching his determination of the "excessiveness" or "inadequacy" of the rates. The factor that is the focal point of the investment-income question is the consideration of a reasonable margin for "profit" or "underwriting profit."[46] Regrettably, the interpretation of the profit-factor provisions has depended significantly on the presence or absence of the "underwriting" adjective.

First, it is not clear that the use of the adjective "underwriting" by the enacting legislature evidences an unquestionable intent to exclude from ratemaking considerations investment income attributable to reserves. The National Association of Insurance Commissioners omitted the adjective from its model fire and casualty rate regulatory bills because "there was some question as to the meaning to be given to the word 'underwriting' and as to what elements should be taken into consideration in determining profit."[47] The industry avowed a firm preference for the adjective,[48] which admittedly makes arguments for non-consideration sound better. Legislative adoption of the industry language, however, is perhaps more appropriately keyed to the strong lobby power of the industry[49] than to any clear manifestation of legislative intent as to what the language should be taken to mean.

Second, those courts which have given more than a cursory analysis to the question of what constitutes profit attributable to underwriting activities have decided that investment income attributable to reserves is a part of that profit.[50] This conclusion is bolstered by the practical fact that if prepaid insurance policies are cancelled, unearned premiums must be refunded, resulting in a decrease of unearned-premium reserves and the cessation of income attributable to that part

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44 Crane, op. cit. supra note 41, at 1.

45 Report of Insurance All-Industry Committee Respecting the Matter of Interstate Cooperation or Compacts, N.A.I.C. Proceedings 158, 160-61 (1951).

46 See, e.g., Casualty and Surety Rate Regulatory Bill, N.A.I.C. Proceedings 397, 398-99 (1946).

47 Report of the Subcommittee of the Committee on Rates and Rating Organizations, id. at 377, 378-79.

48 Ibid.

49 See Keeton & O'Connell 105.

50 See, e.g., Aetna Ins. Co. v. Hyde, notes 22-23 supra and accompanying text; Aetna Ins. Co. v. Commonwealth, notes 24-25 supra and accompanying text.

of the reserves. And if insurers experience a period of greatly reduced losses (an unrealistic but necessary hypothesis), loss provisions in the rates and loss reserve requirements will be reduced accordingly with a similar reduction in investment income.

Finally, the industry's position that its investment and underwriting functions are physically as well as conceptually separate[51] does not preclude the conclusion that part of its investment income is in fact attributable to underwriting activities. If a given company were to be legally reorganized into two separate investment and underwriting corporations, reserve requirements would be the responsibility of the underwriting corporation, and investment income attributable to those reserves would clearly accrue to the benefit of the underwriting corporation, even if it employed the investment corporation to supervise the management of its investments. The conclusion resulting from these considerations was ably stated in 1949 by a member of the New York State Department of Insurance:

> [P]hysical separation of the work . . . should not require that the investment income on assets which were brought into being only through underwriting activities of the company should be completely eliminated in judging the reasonableness of the profits of the company.[52]

The result of this analysis of the specific factor of profit of the companies leads one back to the question of the legality, under the general standard of excessiveness, of rates that do not reflect consideraiton of investment income attributable to reserves. If the regulator has restricted profit to a given amount to prevent rate excessiveness, and, in addition to that profit, the insurer reaps the full benefit of income directly attributable to the activities to which the rate is applicable, the unavoidable conclusion is that the insurer has obtained a return greater than that ordained as reasonable and, therefore, that the rate is prima facie excessive.

It is this analysis, geared to the relevant statutory criteria, that indicates that investment income attributable to reserves (income that is the direct product of underwriting activities) can and should be considered in fire and casualty ratemaking. And this analysis shows, further, that this should be the result whether the statutory provisions speak only of a "reasonable profit" or of an "underwriting profit." Opponents of the consideration of investment income in ratemaking ignore such an analysis of the statutory standards and resort to arguments based on "accepted" meanings, implying if not expressly claiming the support of the National Association of Insurance Commis-

51 See McCollough, supra note 18, at 274-75.
52 Id. at 276.

sioners, and putting heavy emphasis upon well-drawn but questionably relevant chestnuts. It is to these nonanalytic approaches that attention is most frequently, and exclusively, directed; so it is these approaches that must be considered in evaluation of the "anti-consideration" position.

IV. Nonanalytic Approaches to the Investment-Income Question

Reaching a result contrary to the analysis just made, the Arkansas Supreme Court, in *Bullion v. Aetna Ins. Co.*,[53] placed great emphasis on the position of the National Convention (now Association) of Insurance Commissioners as expressed in their "1921 Profit Formula for Fire Insurance."[54] The adoption of that part of the formula that has become the foundation of the non-consideration position has been criticized as a "one-sided compromise" between the commissioners and the insurance industry:

> It is apparent from a reading of the history set forth in . . . the report . . . that the commissioners handled [the problem of giving consideration in the rate formula to investment income attributable to unearned-premium reserves] . . . by compromise. They abandoned their stand on the investment earnings situation and in return the industry representatives agreed to a reduction in the conflagration allowance from 5% to 3%. Twenty-five years hindsight indicates the wisdom of the compromise is highly debatable. First of all, the problem of conflagration allowance and the problem of consideration of investment earnings are two entirely separate propositions which should hardly be offset . . . . Another thing about it is that the reduction in the conflagration allowance was 2% of the premiums. How did the conferees know whether or not the investment earnings eliminated from consideration amounted to 1%, 3% or 5% of the premium income? Further, it is again repeated that the investment income earnings excluded from consideration were actual earnings, while the conflagration allowance that was reduced was a paper figure that had never been attained.[55]

Even if the 1921 formula is accepted as having been the consensus of the National Association of Insurance Commissioners (N.A.I.C.) at its inception, it has never been subsequently given unqualified support

[53] 151 Ark. 519, 237 S.W. 716 (1922). See notes 11, 16, and 18 supra and accompanying text.

[54] Id. at 531, 237 S.W. at 720, quoting Report of Fire Insurance Committee, Proceedings of the National Convention of Insurance Commissioners 19, 20 (1922).

[55] McCollough, supra note 18, at 275.

by that body. In fact, an N.A.I.C. committee considering casualty insurance ratemaking reached a conclusion directly opposed to the position expressed by the formula:

> [A]ny relevant factors increasing or reducing profits must be considered in connection with a determination of the reasonableness of a margin of profit in the rates. Among these relevant factors [is] . . . all investment income excluding realized and unrealized capital gains and losses.[56]

And in its original context of fire insurance ratemaking, the 1921-formula position on exclusion of consideration of investment income attributable to unearned-premium reserves has been specifically questioned by yet another N.A.I.C. committee:

> The Subcommittee is agreed that, to the extent that Point 2 [of the 1921 formula[57]]refers to capital gains or losses on investments, . . . such gains or losses have no place in fire insurance ratemaking.
>
> . . . .
>
> The Subcommittee accepts the established rule of law that all reserve funds of an insurance carrier, including those for unearned premiums and losses, as well as all other assets, are owned by the company, and are in no sense the property of the policyholder . . . . *Nevertheless, this conclusion does not dispose of the following questions*: (a) Whether the investment income of insurance companies is derived in part from such portions of reserve funds as are held *solely as a result of underwriting activities* . . .; (b) the extent of investment income derived from such *underwriting funds*; and (c) whether, if such investment income is not to be considered directly in fire insurance ratemaking, it should be considered indirectly in arriving at a profit factor.[58] (Emphasis added.)

[56] Report of the Casualty and Surety Subcommittee on Cost and Profit Factor Study of Casualty Lines, N.A.I.C. Proceedings 551, 552 (1952). After an attack by the National Bureau of Casualty Underwriters, id. at 565, the subcommittee reaffirmed its stand: "[T]he determination of a reasonable profit for insurance companies [can] . . . not ignore investment income." 1 N.A.I.C. Proceedings 139, 141 (1953). The second report of the subcommittee was incorporated in the report of the full committee without endorsement or adoption. Id. at 139. The full committee report was adopted by the Association. Id. at 150.

[57] See note 18 supra and accompanying text.

[58] Report of the Fire and Marine Special Subcommittee on Underwriting Profit or Loss, N.A.I.C. Proceedings 455, 459-60 (1949). The subcommittee recommended that "a separate study be made by qualified actuaries . . . to determine the extent, if any, of investment income attributable to underwriting activities . . ." and that the subcommittee "be continued for the purpose of this study." Id. at 460. The subcommittee was discharged without reporting in 1955. 1 N.A.I.C. Proceedings 105 (1955).

Moreover, the position of the Association as a whole, as illustrated by the model acts promulgated as a reaction to the McCarran-Ferguson Act,[59] is equally equivocal. In preliminary drafts of the two proposed model bills, the "underwriting" adjective was omitted without comment in connection with the allowance of a reasonable profit for insurers.[60] Final drafts of those bills also omitted the adjective,[61] with the following comment in both bills:

> The All Industry Conference [*sic*] Committee believes the word "underwriting" should precede the word "profit." The National Association of Insurance Commissioners is giving further study to this matter.[62]

This comment was the result of "considerable data which disclosed that there was some question as to the meaning to be given to the word 'underwriting' and to what elements should be taken into consideration in determining profit."[63]

Consequently, the conclusion seems unavoidable that the N.A.I.C. pronouncement in the 1921 formula—that investment income attributable to reserves should not be considered in ratemaking—is no longer a firm premise for the determination of what are "accepted meanings" in "insurance circles."[64] For this reason, "accepted meanings" should certainly be subject to a more penetrating investigation today than is indicated by references to 1921 standards.[65]

In spite of the judicial and administrative decisions to the contrary, and the indefiniteness of the present position of the N.A.I.C., the insurance industry consistently maintains that it has been "demonstrated to practically everyone's satisfaction that investment earnings have no place in ratemaking."[66] Before going into the reasons advanced

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59 See Keeton & O'Connell 524; note 40 supra.

60 Fire and Marine Rating Bill, N.A.I.C. Proceedings 103 (1946); Casualty and Surety Rating Bill, id. at 112, 113.

61 Fire, Marine and Inland Marine Rate Regulatory Bill, id. at 410, 411; Casualty and Surety Rate Regulatory Bill, id. at 397, 398.

62 Id. at 399, 411.

63 Report of the Subcommittee of the Committee on Rates and Rating Organizations, id. at 377, 378-79. The "further study" proposed culminated in a reference of the matter to the Association's Fire and Marine Committee. Report of Committee on Rates and Rating Organizations and on Federal Legislation, N.A.I.C. Proceedings 141, 142 (1947). See also note 56 supra and accompanying text.

64 Bullion v. Aetna Ins. Co., supra note 53, at 526, 237 S.W. at 718. See note 16 supra and accompanying text.

65 But see Insurance Dep't v. City of Philadelphia, 196 Pa. Super. 221, 250, 173 A.2d 811, 825 (1961); notes 19-20 supra and accompanying text.

66 Merrill, Should Investment Income Be Included in Rate-Making, Property & Casualty Ins. Rev., Sept. 11, 1965, p. 24, slightly revised and reprinted as Investment Income, in Best's Ins. News, Oct. 1965, p. 47 (Fire & Casualty ed.) [hereinafter cited as Merrill followed by the page number in Property & Casualty Ins. Rev. and, in parentheses, the page number in Best's Ins. News].

to support this position, it should be noted that it is the industry's opinion that arguments *for* consideration of investment income are purely theoretical; the industry confidently asserts that the principle of the N.A.I.C. 1921 formula has been "followed in the last 44 years for all lines of insurance in all states" and that "no state at any time in the period 1921-1965 has required that investment earnings be included in rate calculations."[67] In addition to past experience in Kansas,[68] Missouri,[69] and Virginia[70] that belies this position, it should be noted that investment income attributable to *reserves* is *presently* considered in ratemaking for fire and casualty insurance in at least three states—New York,[71] Missouri,[72] and Virginia.[73] In addition,

> the New York Insurance Department has traditionally taken into consideration the investment earnings available to insurers. . . . *All* forms of "investment income," including investment of the funds held for unearned premium reserves, loss reserves, and undistributed earnings or surplus, are studied . . . as a basis for determining the reasonableness of the underwriting provision for profit or contingencies in insurance rates.[74]

Moreover, while condemning the pro-consideration arguments as purely "theoretical," the industry has never argued that, as a matter of actuarial or regulatory theory, the consideration of investment income attributable to reserves would result in "inadequate" rates, or that the non-consideration of such income does not result in "excessive" rates. Rather, in defending its position, the industry has adopted what used to be called, in high-school-debate parlance, a "shot-gun approach," filling the air with a veritable barrage of pellet-like arguments,[75] with

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67 Ibid. See also National Association of Independent Insurers, Investment Income 1 (unpub.); Texas Board of Insurance, Investment Income 1 (unpub.).

68 Notes 28-32 supra and accompanying text.

69 Notes 22-23 supra and accompanying text.

70 Notes 24-27 supra and accompanying text.

71 Letter from Frank Harwayne, Chief Actuary, New York Department of Insurance, Nov. 5, 1965.

72 Mo. Rev. Stat. § 379.385 (1959). See note 26 supra.

73 Letters from T. Nelson Parker, Virginia Commissioner of Insurance, Nov. 24, 1965, and April 27, 1966. It should also be noted that in a fourth state, Massachusetts, a 1% profit factor is set for compulsory motor vehicle liability insurance as a reflection of investment income. Letter from C. Eugene Farnam, Massachusetts Commissioner of Insurance, Oct. 22, 1965. In two other states, Kentucky and Maryland, consideration of investment income in motor vehicle liability insurance ratemaking was recently initiated by the insurance regulators. See notes 14, 33-34 supra and accompanying text.

74 Letter from Frank Harwayne, supra note 71.

75 See the numerous arguments presented in National Association of Independent Insurers, Investment Income (unpub.) [hereinafter cited as N.A.I.I.]; National Bureau of Casualty Underwriters, Memorandum . . . in Reply to the Report . . . of the Sub-

little regard for their analytical firmness or relevance. In dealing with the "shot-gun" approach, one is faced with the dilemma of whether, on the one hand, to deal with each argument, thereby risking a superficial treatment of all arguments, or, on the other hand, to select only a few representative arguments at the risk of the response that the "important" points are not met at all. This article will take the risk of the latter course, presenting and discussing a few arguments that are representative of the industry's position.

Though the industry's position is that no investment income of any kind should be considered in ratemaking, arguments relative only to investment income attributable to capital accounts are intermingled with other arguments relative only to investment income attributable to reserves and with still more arguments relative to both—without any analysis of the applicability of the arguments. Many of these arguments are, at best, irrelevant.[76] They are considered here not because of their apparent strength or logical underpinnings, but because of the ease with which unrebutted positions of the industry are accepted without question in an area as filled with complexity as that of ratemaking.[77]

> The industry often argues that the funds of stock companies and any profit made on their investments . . . belong to the companies and their stockholders, not to policyholders. The

Committee on the Study of Cost and Profit Factors of Casualty Lines, N.A.I.C. Proceedings 565 (1952) [hereinafter cited as N.B.C.U. Memorandum]; Merrill 24 (47). Many of the arguments are duplicated in the foregoing materials, yet none of the sources cited utilizes all of the arguments.

See also Massachusetts Special Commission, Report on the Investigation and Study of the Motor Vehicle Laws and the Insurance Laws as They Relate to Motor Vehicles 97 (1959), and Texas Board of Insurance, Investment Income (unpub.) for governmental echoing of the industry arguments. These latter sources give express recognition to an argument that is only implied in the sources directly connected with the industry, i.e., that the N.A.I.C. "consistently" supports the practice of not considering investment income in fire and casualty insurance ratemaking. The weakness of this argument has already been demonstrated. See pp. 723-25 supra.

76 Indicative of the overall tone of the industry's position is the following "analogy" and prefatory comment thereto made by the National Association of Independent Insurers:

> From time to time a small element of the plaintiff's bar [a traditional foe of the industry] will inject the subject of investment income into rate hearings. . . . They know this is a fatuous proposal and pure demagoguery.
>
> It makes as much sense as asking a plaintiff lawyer, when setting the fee he charges his clients, to allow them a credit for his investment income from all sources and the growth of his investment portfolio. The higher his dividends and the greater his stock appreciation, the less he would charge. (Many people are not aware that the fees of plaintiff lawyers average from one-third to 50 per cent of the gross settlement or award.)

N.A.I.I. 5.

77 For an example of such acceptance, see, e.g., Texas Board of Insurance, Investment Income (unpub.).

> policyholder obtains what he pays for—his insurance policy and its protection—not a share in the property of the company . . . .[78]

As a committee of the N.A.I.C. has stated, the acceptance of the basic premise of this argument does not "dispose of the [question] . . . whether, if . . . investment income is not to be considered directly in . . . insurance rate making, it should be considered indirectly in arriving at a profit factor."[79] First, the question is *not* who owns the invested funds, but rather, are the funds directly attributable to premiums paid by policyholders and, if so, should the profit realized on these funds be reflected in what the policyholder has to pay. Approached from this point of view, the technical qualities of "ownership" are unimportant; this is particularly true when the primary question is what is the reasonable profit that the company should be allowed on the insurance premium paid by the insured. Further, there is no argument that what the insured is paying for is the protection of an insurance contract; the relevant question there is: In view of the statutory criteria, is the insured paying too much for what he wants and gets? Nor can it be said that the pro-consideration position means giving the policyholder a "share" in the property of the company; this is just as preposterous as saying that the policyholder must be personally liable for the company's debts because part of the premium paid reflects the expense experience of the company.

A second industry position is that "it would be unjust . . . to reflect the income from investments in the insurance rate without also

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78 Merrill 24 (47). See also N.B.C.U. Memorandum 584. Merrill cites, in support of this proposition, Aetna Ins. Co. v. Hyde, 34 F.2d 185 (W.D. Mo. 1929). The authority of that case is negligible. See note 27 supra. In addition, support is garnered by the citation of two life-insurance cases. Merrill 24 (48). Disregarding the howls of anguish and the charges of inapplicability that arise when pro-consideration writers point to the consideration given to investment income in the life-insurance field—see Leslie, Investment Income and the Profit and Contingency Factor in Rate Making, Proceedings of Conference of Actuaries in Public Practice 82, 84-85 (1955-56)—the present status of the concept of "ownership" of reserve funds in the field of life insurance is not so clear as the industry would have us believe. See United States v. Atlas Life Ins. Co., 381 U.S. 233, 247-48 (1965) (dictum). A corollary argument is that

> the company owns the premiums paid by the insured as much as the bank owns a deposit made by its depositor. The company is no more bound to credit policyholders with . . . investment returns on premiums . . . than a bank is obliged to credit depositors with profits made from the investment of deposit funds. . . .

Merrill 24 (47). Without recourse to a point-by-point comparison, it is apparent that different economic theories, regulatory standards and governing rules (to say nothing of actual practices) are applicable to the two—even if the premise of the argument is accepted. The analogy is, at best, tenuous.

79 Report of the Fire and Marine Special Subcommittee on Underwriting Profit or Loss, N.A.I.C. Proceedings 455, 459-60 (1949). See note 58 supra and accompanying text.

reflecting the loss or lack of such income in the rates."[80] In answer to this, one might ask: How does one *lose* income? Either income is realized or it isn't. The only losses connected with investments are *capital* losses. Few proponents of considering investment income attributable to reserves, including this author, would extend that consideration to either capital gains or losses,[81] subject as those gains or losses would be to the vagaries of an often skittish market and to the control, especially in regard to timing and amount of losses, of the companies themselves. As to the *lack* of income, certainly the companies would be "subsidized" to the extent that there is no investment income to constitute a part of the reasonable profit allowed. That is, in considering investment income, the insurers would be allowed a factor in the rates that, together with the investment income considered, would constitute a reasonable profit. No one would deny them that.[82] If there is *no* investment income to be considered, the entire amount determined as a reasonable profit would then be the profit factor in the rates.[83] In view of the size of the funds in question, however, the likelihood of lack of income is at best remote:

> The handling of almost one and a quarter billions of new money each year . . . ought to produce some investment income, even considering the legal restrictions on investments of fire insurance companies. In fact, if it were contended that sums of this size are managed without return, doubts might well be raised as to the competency of those responsible for such a result.[84]

A third argument of insurers is that "to use aggregates of investment income for rate-making would tend to make companies seek high yield investments. . . . This would jeopardize the security of companies and be harmful to the best interests of policyholders."[85] It is always somewhat amusing to hear proprietors of an obviously

80 N.B.C.U. Memorandum 587. See also N.A.I.I. 1, 5; Merrill 24 (47).

81 See, e.g., Aetna Ins. Co. v. Hyde, 315 Mo. 113, 138, 285 S.W. 65, 73 (1926), cert. dismissed, 275 U.S. 440 (1927). See text accompanying note 22 supra.

82 See Leslie, supra note 78, at 86.

83 It should be remembered that, for the most part, insurers are now allowed *both* that reasonable profit in the rates *and* investment income attributable to reserves.

Another means of reflecting investment income—the discounting of loss allowances in the rates by the amount of projected income on the investment of reserves—has been suggested in the workmen's-compensation-insurance field. Callahan, Costs, Operations and Procedures Under the Workmen's Compensation Law of the State of New York 98-100 (1957). Under this approach, if the insurers had during the relevant experience period—i.e., that period used for purposes of projection—a record of no income on investments, there would be no discounting of loss allowances.

84 New York Insurance Department, Fire Insurance Terms and Discounts 31 (1950), as quoted in Leslie, supra note 78, at 84.

85 N.B.C.U. Memorandum 586. See also Merrill 24 (47).

successful business bemoaning their own lack of business acumen. If investment income is to be considered in ratemaking, it is hardly likely that the industry's reaction, without reflection on any other business considerations, will be to garner as much investment income as possible, regardless of the risks involved. Assuming, however, that the industry would act in such a simple-minded manner, investments of insurance companies, particularly investments of monies attributable to reserve requirements, are or can be the subject of close regulation by the state;[86] if the companies do not have the good sense to maintain their own stability in their own self interest, the state is there to look after the "best interests of policyholders."

Another argument often advanced by industry is that "it would be unjust to confer upon a new policyholder a financial benefit accruing from capital and accumulated surplus to which he did not contribute."[87] This argument is by definition relevant only to the question of consideration of investment income attributable to capital accounts. Even so, while the industry implicitly admits that even those accounts are traceable to policyholders' "contributions," they argue that *every* policyholder should be denied any "benefit" because (1) his "contribution" will not return any income until some point in the future, and (2) the return which is being realized at present is attributable to "contributions" made in the past; by virtue of this conceptual difficulty, the industry concludes that only the companies should benefit from those "contributions." Reserve funds are even more clearly "contributions" of policyholders and are more immediately the product of underwriting activities; therefore, it is clearly inequitable that the companies should derive the full benefit of income realized on these contributions. If the investment-income experience of prior years is utilized to project an anticipated return on investments attributable to reserves required against present premium receipts (in the same manner that loss and expense factors in present rates are a projection based on a prior experience period), the benefit of the policyholder would, in theory, result from his own contribution, and the conceptual difficulty of the industry would be avoided.

The final industry argument with which this article will deal is that "country wide underwriting results in the last decade clearly point to the inadequacy of current rates on a nationwide basis . . . . It should be abundantly clear that it is preposterous to even consider lowering current rates by the inclusion of imaginary investment earnings . . . ."[88] If, however, rates have been so clearly inadequate, why have the

86 See, e.g., N.Y. Ins. Law §§ 80-81 (McKinney 1966).

87 Merrill 24 (47). See also N.A.I.I. 4; N.B.C.U. Memorandum 585.

88 Merrill 25 (49, 52). See also N.A.I.I. 2.

companies not been vindicated in the courts?[89] These protestations of loss have not gone unchallenged.[90] Among other problems with the argument, it must be noted that the "underwriting loss" experience of which the industry complains is tabulated without considering investment income and without regard to whether the *total* experience has resulted in profit or loss to the companies.[91] As to the question whether investment earnings are indeed "imaginary," from 1959 to 1963 "the capital stock segment of [the fire and casualty] . . . industry wrote $56,000,000,000 of insurance premiums . . . and *net* investment income amounted to $3,519,000,000."[92] (Emphasis added.) Admittedly, this figure includes all investment income, but the industry is curiously reluctant to reveal the amount of investment income earned attributable to reserves.[93]

In summary, it would seem that the industry should stop grasping at straws and rising in questionably righteous wrath at the drop of the investment-income question; if there are sound bases for opposing consideration of investment income in ratemaking, bases grounded in actuarial theory or the relevant statutory standards, they should be presented in a logical, analytical format without obfuscation of the issue with irrelevancies and ill-considered analogies. Perhaps the lack of such arguments indicates an inability to find real support in either actuarial theory or regulatory standards.[94]

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89 In Massachusetts, where the industry perennially decries the continuing inadequacy of compulsory motor vehicle liability insurance rates and the enormous losses that they incur on this line—see, e.g., Casualty Insurance Companies Serving Massachusetts, The First Thirty Years: A Commentary on the Operation of the Massachusetts Compulsory Automobile Liability Insurance Act 10-12, 20-22 (1957)—the courts have found the rate set by the state to be inadequate only once in over thirty years. American Employers' Ins. Co. v. Commissioner of Ins., 335 Mass. 748, 142 N.E.2d 341 (1957).

90 See, e.g., Keeton & O'Connell 93-94.

91 Id. at 94 n.84.

92 Merrill 28 (53).

93 Estimates have, however, been made by informed nonindustry participants in the investment-income controversy. Mr. Charles K. Leslie, formerly an actuary with the Texas Board of Insurance and presently an insurance consultant in Houston, Texas, has been quoted as stating that

> in the 1954-'63 period, the 800 stock insurance companies that wrote fire and casualty coverage . . . gained $3,373,669,910 [in income from the investment of unearned-premium reserves] . . . . Adding this amount to the figure gained on investing claim reserves ($2,637,858,796 . . .), Leslie reports that *stock* companies gained $6,011,528,706 for the decade [in] . . . net worth [from] . . . these two disputed types of investment income . . . .

Texas Observer, Dec. 30, 1966, p. 3, col. 1.

94 Several other of the industry's arguments should be mentioned. Mr. Fred Merrill, whose positions are representative, has argued that if "investment income were included in ratemaking, companies which settled claims promptly would be penalized because they would not have the opportunity to earn interest equivalent to that taken into account in developing rates." Merrill 24 (47). This, however, applies only to investment income attributable to *loss* reserves, and it is generally known that large loss claims,

V. CONCLUSION

The Virginia courts,[95] the Virginia regulator,[96] and the Maryland regulator[97] are in accord with the conclusion that investment income

the main reason for large loss reserves, are the most hotly contested and the least likely to be settled promptly. Keeton & O'Connell 37-38.

Mr. Merrill also feels that the present rates are putting the insurance industry in a bad position as a competitor for capital because of low return. Merrill 25, 28 (52-53). See also N.A.I.I. 3-4. As is the usual case with industry propaganda, "return" is first calculated as a percentage of assets and compared with other industries on that basis. Merrill 25 (52); N.A.I.I. 3. This is a realistic, or at least a permissible calculation if assets are roughly equivalent to stockholder's equity; but in the insurance industry this is not the case. See Leslie, supra note 78, at 82, 86, 88-89. Mr. Merrill does, however, state a percentage return related to capital and surplus—a matter generally avoided by the insurance representatives. See, e.g., N.A.I.I. 3-4. However, he compares that return to that available in such industries as steel, chemical, and drugs. Merrill 25 (52). Investors are surely aware, or ought to be, of the legal limitations on the profits and investments of insurance companies; the insurance business, therefore, would not have the appeal of a venture unregulated as to profits in any case. Rather, because of the presence of relatively strict government regulation, investment in insurance stock is, like investment in public-utility stock, a safe one, the acceptance of a low return being the price paid for security. If a comparison is to be made, it should be to the return on similarly regulated monopolistic or oligopolistic ventures.

Finally, when Mr. Merrill decries the fact that the industry is not bearing its share of the federal tax load because of "underwriting" losses and the more favorable treatment given under the tax law to investment income of the companies, id. at 28 (53), one can only ponder the probable relationship between tongue and cheek!

Two additional arguments advanced by the National Association of Independent Insurers should also be mentioned. First, the Association argues that "for the small and medium-size companies . . . investment income is not a paramount factor in their over-all financial picture. . . . While the modest return from these investments is helpful, it is by no means lavish." N.A.I.I. 3. This is a delicate statement of the proposition that investment income is insignificant, and that consideration of it in ratemaking would not amount to any real savings for the insured. See Massachusetts Bonding & Ins. Co. v. Commissioner of Ins., 329 Mass. 265, 281, 107 N.E.2d 807, 816 (1952) (dictum). Even so,

> the mere fact that [investment income] . . . may be a comparatively small element in rate making and have an almost insignificant effect on rate charges from year to year, should not warrant our disregarding it. There are many refinements in rate making which are also comparatively insignificant. We mention "disease loading," "catastrophe loading," "loss constant offset," and "off-balance factor," as just a few.

Leslie, supra note 78, at 90-91.

The second argument of the Association of Independent Insurers is that "if you were . . . to consider the total investment income of a multi-line property and casualty insurance company in arriving at an auto B.I. [bodily injury] rate, you would have the insured of one line subsidizing the insureds of another line." N.A.I.I. 4. Only the industry is capable of drawing such black pictures, premised on unstated and unlikely assumptions, e.g., that no proration of investment income to specific lines of insurance and to the geographical jurisdiction of the regulating authority can or will be made. It is hardly likely that any regulator would follow this course or that the courts would allow it if one did. As with nationwide expense experience, any consideration of investment income would have to be correlated to the particular line of insurance, to the volume of premiums written within the state on that insurance, and to the reserves required to be held against the premium volume.

95 See note 24 supra and accompanying text.

96 See note 25 supra.

97 See note 34 supra and accompanying text.

attributable to reserves both can and should be considered in fire and casualty insurance ratemaking, irrespective of the presence or absence of the "underwriting-profit" totem in the statutory language. The same is true in New York[98] and Missouri[99] with reference to whether consideration *should* be given. And other writers concur, though without consideration of the apparent problem of the "underwriting-profit" totem.[100] Even so, many state regulators feel that they are prohibited from considering investment income in ratemaking by the presence of the totem in their statutes,[101] and others, accepting the industry's position seemingly without question,[102] do not feel that they are "required" by their law to give such consideration.[103] Regrettably, these positions will most likely be arbitrarily sustained by the courts.[104]

Accepting this probability, it is apparent that specific legislative action is necessary to ensure (1) that rates will truly provide only that reasonable profit to which insurers are entitled and (2) that if and when current developments in actuarial theory that would consider investment earnings[105] come to fruition, the law will not prohibit the effectuation of that theory. One course that such legislation might take is the simple deletion from the statutes of the word "underwriting" in connection with "reasonable profit"; such a statute presently allows the New York regulator to give full consideration to investment earnings.[106] A more direct and affirmative approach would be to insert into the ratemaking provisions a section comparable to that under which the Missouri regulator has reviewed fire and casualty rates for almost

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98 See notes 71 and 74 supra and accompanying text. See also N.Y. Ins. Law § 183(1)(d) (McKinney 1966).

99 See note 26 supra.

100 Leslie, note 78 supra; McCollough, Reply to Statement of the Committee on Laws, National Board of Fire Underwriters, N.A.I.C. Proceedings 258 (1949).

101 E.g., letter from Frank Sullivan, Kansas Commissioner of Insurance, Nov. 15, 1965.

102 E.g., Texas Board of Insurance, Investment Income (unpub.).

103 Letter from Willis A. McVey, Assistant Casualty Actuary, Texas Board of Insurance, Nov. 9, 1965.

104 See Insurance Dep't v. City of Philadelphia, 196 Pa. Super. 221, 173 A.2d 811 (1961); Brown v. State Board of Ins., No. 145,243-A, Dist. Ct., Travis County, Tex., Jan. 24, 1966; Bader v. State Board of Ins., No. 145,243, Dist. Ct., Travis County, Tex., Oct. 19, 1965. The Texas cases were appeals from a decision of the Texas Board of Insurance that had rejected consideration of investment income attributable to reserves in motor vehicle liability insurance ratemaking. Even though the applicable statutory provisions, Tex. Ins. Code Ann. arts. 5.01-.12 (1963), do not contain the "underwriting-profit" totem, summary judgments were granted against the proponents of consideration. Further appeals were not perfected. Letter from Willis A. McVey, Assistant Casualty Actuary, Texas Board of Insurance, Feb. 7, 1967.

105 See e.g., Leslie, supra note 78.

106 N.Y. Ins. Law § 183(1)(d) (McKinney 1966); letter from Frank Harwayne, Chief Actuary, New York Department of Insurance, Nov. 5, 1965.

forty years: "[H]e shall . . . take into consideration . . . all earnings of such companies, including investment profits."[107]

It is recognized that the insurance industry is a powerful lobby in practically every state legislature,[108] and that the full force of that power would be employed against the enactment of such legislation. But when it is taken into account (1) that the basis for the non-consideration position in the National Association of Insurance Commissioner's "view" can no longer be supported, (2) that the arguments thus far advanced by the industry are without substantial foundation in logic or fact, (3) that an analytical approach requires consideration, and (4) that New York, Missouri, and Virginia have demonstrated that consideration of investment income is both necessary and feasible, the necessity to overcome this power ought to be manifest. Steps should then be taken to ensure that rates will be calculated on the basis that is most clearly in the public interest.

107 Mo. Rev. Stat. § 379.385 (1959). See note 26 supra.
108 Keeton & O'Connell 105 n.118.