

Chapter 1

The Insurance Industry

Few industries are as large or as little understood as the insurance industry. In 1985, Americans spent \$300 billion to purchase insurance coverages, an average of \$1,257 for every person living in the United States. The industry employs more than two million persons as agents, underwriters, brokers, or support personnel (Insurance Information Institute, 1986; 12). Americans routinely insure their lives, their homes, their automobiles, and their health. Without insurance, goods would not be transported, large construction projects would be impossible, and the overall quality of life would decline greatly. Despite the importance of insurance in the daily lives of individuals, people understand the insurance industry about as well as they understand their homeowners' insurance policy.

If the industry is mysterious, it is no more so than the politics involving the insurance industry. Even though insurance is the largest state-regulated industry in the United States, political scientists have ignored the political economy of insurance regulation. Only one book on insurance has ever been published by a political scientist and that covered only a minor part of the industry (regulation of investments; see Orren, 1974). Scholarly articles on the industry are also sparse.¹

This chapter presents the reader with a brief overview of the insurance industry. To provide the background necessary to understand the various issues of insurance politics, some detail about the industry's structure and products is necessary.

The Life Insurance Industry

The insurance industry is not one industry but rather several industries with firms generally specializing in specific lines of insurance. The industry itself distinguishes between the life insurance and the property and casualty (PC) insurance industries. The life insurance industry contains not only life

insurance but also private health insurance companies.² The property and casualty insurance industry consists of the companies that sell all other types of insurance. The distinction between life and health and property and casualty insurance companies was once required by law but now is more tradition than anything else. Most property and casualty companies have life insurance affiliates, and a smaller portion of life insurance companies have property and casualty affiliates.

The 2,600 life and health insurance companies annually collect \$156 billion in premiums and earn an additional \$78 billion from investments (see Table 1). Unlike most other industries where the profit-making corporation is the norm, many large U. S. life insurance companies are organized as mutuals. Mutual organizations are technically owned by policymakers; purchasing a policy gives an individual an equity share in the company and results in profits returned to the policyholder as dividends. Although only 132 life insurance companies operate as mutuals (the rest are stock companies, the traditional business form), the mutuals control nearly one-half of all life insurance company assets.

The life/health insurance industry offers three basic products—life insurance, annuities, and health insurance. Life insurance comes in a variety of forms including whole life, term, group, and universal life. A life insurance contract essentially builds an estate for an individual, thereby protecting that individual's family from the financial dangers of an untimely death. Annuities are a contract to protect individuals from the financial penalties of old age. An annuity pays an individual a specified income beginning at a certain age and continuing to that person's death. Health insurance, of course, is a contract that obligates the insurance company to pay for health care costs that policyholders incur.

PRODUCT MIX

The mix of products sold by the life insurance industry has varied over time. As Table 1–2 reveals, life insurance was virtually the only product sold by the life insurance industry before 1920. Throughout the last 65 years, the proportion of life insurance company premiums from life insurance has decreased to 38 percent of the total. Annuities and health insurance each contribute approximately 30 percent of these companies' incomes.³

Although the insurance industry defines life and health insurance as a single industry, the products have different economic characteristics. Both life insurance and annuities have a long timeframe focus; individuals pay money now for expected future benefits. The contracts are individually based in that benefits to individuals are precisely defined in terms of face value or

Table 1-1
Income Generated by the Insurance Industries (billions)

	Life/Health	Property/Casualty
Premium Income	\$156 ^a	\$144 ^b
Investment and Other Income	78	14
Total Income	234	158
Assets	826	311 ^c

^aFor 1985, source ACLI, 1986.

^bFor 1985, source *Best's Review*, 1986.

^cSource, Insurance Information Institute, 1986.

Table 1-2
Premium Income for Life Insurance Companies

	Percent Insurance	Percent Annuities	Percent Health	Total (billions)
1920	99.4%	.6%	0 %	\$1.4
1940	90.0	10.0	0	\$3.9
1960	69.1	7.7	23.2	\$17.4
1970	59.0	10.1	30.9	\$36.8
1980	44.0	24.2	31.7	\$92.6
1985	38.6	35.6	26.8	\$155.9

Source: ACLI, *Life Insurance Fact Book*, annual.

yield. As a result, the cash-flow situation for these products is very positive (that is, income annually exceeds expenses by large amounts; see Table 1-3). Insurance companies issuing these products receive premiums that they are free to invest for many years until the money is needed. Health insurance is much more a pay-as-you-go business for the insurance industry. Health insurance companies annually pay out 66¢ in benefits for every \$1 of premiums they collect. Group health insurance is even more short term, the annual benefits to premiums ratio for group insurance is .78 (ACLI, 1985). In addition, health insurance contracts are not individual contracts in the sense that an individual is not limited to collecting a specified amount in benefits.

GROWTH

Life insurance is a rapidly growing industry. According to Table 1-4, the face value (that is, the death benefit) of life insurance in force grew by 71 percent in the five years from 1980 to 1985. Currently, Americans hold life insurance with a face value of \$6.1 trillion. Obviously, an industry that expects to pay individuals \$6.1 trillion sometime in the future based on an annual premium income of \$156 billion is intending to make some money on

Table 1-3
Cash Flow for Life Insurance Companies (millions)

	<i>Benefits Paid</i>	<i>Premiums</i>	<i>Return Rate</i>
Life Insurance ^a	\$16,572	\$51,274	32.7%
Annuities	17,912	42,859	41.7%
Health Insurance	27,053	40,651	66.5%
All Life Insurance Payments	42,520 ^b	51,274	82.9%

^aIncludes death benefits only.

^bIncludes death benefits, surrender values, and dividends.

Source: ACLI, 1985.

Table 1-4
Total U. S. Life Insurance in Force (billions)

1920	\$40.5
1940	\$115.5
1960	\$586.4
1970	\$1,402.1
1980	\$3,541.0
1985	\$6,053.1

Source: ACLI, *Life Insurance Fact Book*, annual.

investments. Life insurance companies are financial intermediaries; they collect savings (that is, premiums) from individuals and invest these savings in the economy. In this sense, they are similar to banks, brokerage firms, or pension funds. Funds invested by life insurance companies are termed *assets*. Life insurance company assets have increased by 72 percent since 1980 and totaled \$826 billion in 1985 (see Table 1-5).

The importance of life insurance companies as financial intermediaries is illustrated by Table 1-6. Life insurance companies provide as much money for the U. S. economy as do all the nation's savings and loans associations. Only commercial banks are a larger financial intermediary than life insurance companies. Life insurance companies' assets exceed those of mutual savings banks, credit unions, state and local government pension funds, and all private (that is, noninsurance company run) pension plans.

With large sums of money to invest, decisions made by life insurance companies have ramifications for the national economy. Where life insurance companies invest their money often depends on where the companies feel they can get the best long-term return on investment. Unlike property and casualty companies that must keep a large portion of their investments liquid to pay claims, life insurance companies often do not anticipate paying bene-

Table 1-5
Total Assets of Life Insurance Companies

1920	\$7.3
1940	\$30.8
1960	\$119.6
1970	\$207.3
1980	\$479.2
1985	\$825.9

Source, ACLI, *Life Insurance Fact Book*, annual.

Table 1-6
Assets of Major Financial Intermediaries—1984

Intermediary	Assets (billions)
Life Insurance Companies	\$723
Property and Casualty Insurance Companies	264
Savings Associations	724 ^a
Commercial Banks	1,056 ^a
Credit Unions	108 ^a
Private Pension Plans	608 ^b
State and Local Government Pension Plans	290 ^b

^aAmerican League of Savings Associations, *Savings Association Fact Book*, 1985.

^bACLI, *Pension Facts*, 1985.

fits for 20, 30, 40 or more years in the future. This longer viewpoint allows the insurance company to make longer term investments than can be made by many individuals or by other financial intermediaries.

The distributions of life insurance company investments for 1945, 1975, and 1985 are shown in Table 1-7. Despite the magnitude of their investments, insurance companies move their money to different categories of investments over time. Intracategory movement is even greater. For example, with few domestic investment opportunities and the strong demand for war-related funds, insurance companies invested heavily in government securities in 1945. Over time these securities were sold or redeemed, and investments were made in corporate bonds and mortgages. In recent years, the unattractive rates associated with long-term mortgages have resulted in fewer investments in home mortgages and more investments in other types of assets.

These investment patterns show that life insurance companies are major financial players competing with commercial banks in the corporate bond market and savings associations in the mortgage market. Life insurance companies are not as important in the stock market or in real estate markets because many state laws either have or once had restrictions prohibiting life

Table 1-7
The Distribution in Life Insurance Assets

	1945	1975	1985
Government Securities	50.3%	5.2%	15.0%
Corporate Bonds	22.5	36.6	36.0
Corporate Stocks	2.2	9.7	9.4
Mortgages	14.8	30.8	20.8
Real Estate	1.9	3.3	3.5
Policy Loans	4.4	8.5	6.6
Miscellaneous	3.9	5.9	8.7
Total (billions)	\$44.8	\$289.3	\$825.9

Source: ACLI, *Life Insurance Factbook*, annual.

insurance investments in real estate or stocks (see Chapter 5). Policy loans are, of course, a unique investment for life insurance companies; these assets are loans to policyholders with the cash value of the insurance policies as collateral.⁴

INDUSTRY STRUCTURE

With 2,260 firms nationwide, the life insurance industry has the potential to be a competitive industry. Although companies must be licensed in each state where they sell insurance, many companies sell life insurance in virtually all 50 states. The gigantic size of the industry means that the leading industry firms are by definition large corporations (35 mutuals and 80 stock companies had 1985 assets in excess of \$1 billion), but even so the life insurance industry is not especially concentrated compared to other industries. Table 1-8 shows the ten largest life insurance companies ranked according to assets in 1965 and 1985. Although most of these companies quadrupled their assets in the past 20 years and although nine of the top ten companies in 1965 remained there in 1985, industry concentration declined. The percentage of assets controlled by the three largest firms declined from 35.9 percent to 27.1 percent; the portion controlled by the top five firms dropped 11 percentiles, and the portion controlled by the top ten dropped 10 percentiles.

Despite the large size of the industry leaders, the life insurance industry does not have excessive barriers to entry or exit. For the 1980s, between 100 and 150 new life insurance firms were founded annually. The capital requirements to start a new life insurance company vary by state, and in some states capital requirements are modest. (See Chapter 7 on capital requirements.) A life insurance company is prevented by regulation from simply exiting from

Table 1-8
 Ten Largest Life Insurance Companies
 Assets 1965-1985 (billions)

1985		1965	
Company	Assets	Company	Assets
1. Prudential	\$91.1	1. Metropolitan	\$22.5
2. Metropolitan	76.5	2. Prudential	22.4
3. Equitable	48.0	3. Equitable	12.2
4. Aetna*	37.9	4. New York Life	8.9
5. New York Life	28.0	5. John Hancock	8.0
6. John Hancock	26.3	6. Aetna*	5.5
7. Travelers*	25.6	7. Northwestern	5.1
8. TIAA*	23.2	8. Travelers*	3.8
9. Conn. General*	22.2	9. Conn. General*	3.3
10. Northwestern	17.9	10. Mass. Mutual	3.3
Assets Held by Top 3	27.1%	1965	35.9%
Assets Held by Top 5	35.4%	1965	46.6%
Assets Held by Top 10	49.9%	1965	59.8%

*Indicates stock company; all others are mutuals.

Source: *Best's Review*, July 1986 and ACLI, *Life Insurance Fact Book*, annual.

the market because individuals purchase life insurance and annuities now with the expectation of future payments. Despite regulatory restrictions, life insurance companies can exit from the industry by selling their policies to another company, merging with another company, or undergoing liquidation by a state regulator. During the 1980s, between 80 and 100 firms annually exited the market; most merged with other life insurance companies.

The Property and Casualty Industries

The property and casualty insurance industry has 3,500 separate companies collecting \$144 billion in insurance premiums annually. The property and casualty industry is more heterogeneous than the life insurance industry; it is divided into specialties called "lines of insurance." The major lines of property and casualty insurance, though by no means all lines, are shown in Table 1-10. Each line is, in reality, a separate industry. In the early twentieth century insurance companies generally wrote insurance in only one line (see Chapter 5) because state laws limited companies to specified lines of insurance. Although such restrictions no longer exist and approximately 900 multiline companies operate nationwide, some specialization is still found.

Table 1-9
Entry and Exit of Life Insurance Companies

Year	Total Companies	New Companies	Exits
1980	1958	155	92
1981	1991	137	104
1982	2060	152	83
1983	2117	137	80
1984	2193	166	90
1985	2260	NA	NA

Source: ACLI, 1986.

Table 1-10
Property and Casualty Insurance Lines

Line	1985			10-Year ALR
	Premiums ^a (billions)	Percent	% Growth Since 1976	
Automobile	61.3	42.5	139%	70.2
Inland Marine	3.7	2.6	154%	58.9
Health and Accident	3.2	2.2	51%	86.6
Workers Compensation	17.0	11.8	126%	72.9
General Liability	11.5	8.0	172%	67.5
Medical Malpractice	2.8	1.9	145%	90.4
Fire and Allied Lines	6.2	4.3	51%	56.6
Homeowners	14.1	9.8	147%	63.3
Commercial Multiple Peril	12.1	8.4	199%	61.4
Ocean Marine	1.2	.8	30%	73.0
Surety	2.3	1.6	285%	40.2
Reinsurance	5.2	3.6	323%	80.6
All other lines	3.6	2.5	—	—
Total	144.2	100.0	138%	68.9

ALR—adjusted loss ratio.

Source: *Best's Aggregates & Averages 1986*.

Insurance companies prefer to write insurance in lines where they have experience. A major automobile insurance company, for example, would be unlikely to offer medical malpractice insurance.

The largest single line of property and casualty insurance is for automobiles; it comprises 42.5 percent of the P/C market. Although the industry further divides automobile insurance into private passenger and commercial insurance and into property damage and liability insurance, automobile insurance can be considered a single industry. The marketing mechanisms for private passenger and commercial automobile insurance differ, however. Pri-

vate passenger automobile insurance has numerous buyers with no single buyer exerting any appreciable influence on the market price. Commercial automobile insurance has large corporate buyers and local governments who are sometimes capable of exerting market power. Commercial automobile insurance policies also can be customized to the buyer while private passenger policies rarely are.⁵

These differences in product result in differences in industry structure. The private passenger automobile insurance market is dominated by direct writers. Direct writers are insurance companies that employ their own sales and claims staffs in contrast with companies that use independent agents to sell and service their policies. Direct writers, because they are more efficient, are able to sell individual insurance policies at a lower price. Direct writers (for example, State Farm, Allstate, Nationwide) control 53 percent of the automobile insurance market and 61 percent of the private passenger market (Wasilewski, 1986b: 14ff). In commercial automobile policies where the mass-marketed, uniform policy is less useful, direct writers have only 21 percent of the market.

Workers' compensation insurance, the second largest property and casualty line, is insurance purchased by industries to pay claims filed by workers injured on the job. Workers' compensation is a complex policy area that merits study by itself (see Chiet, 1961; Williams, 1981; Gersuny, 1981); it will not be covered in this book. One interesting market structure aspect of workers' compensation insurance is that some state government agencies sell workers' compensation insurance in competition with private companies; in other states, the government has reserved a monopoly in workers' compensation insurance for itself.

Homeowners' insurance is a multiple peril type of insurance that covers homeowners for damages from fire, weather (but not flooding), and accidents to visitors among other things. Homeowners' insurance has a marketing structure much like that of private passenger automobile insurance: standard policies can be mass marketed. This \$14 billion per year industry is dominated by direct writers who control 46.7 percent of the market.

At one time, commercial insurance as well as homeowners insurance was written only on a single line basis. Business owners had to buy one insurance policy for fire coverage, another for theft, another for broken glass, and another for boilers. The dominant insurance companies at this time were in fire insurance, but with the rise of multiline companies (see Chapter 5), fire insurance and its allied lines has become a minor line of insurance with only 4.3 percent of the market. Fire insurance for business has been replaced by commercial multiple peril insurance which consolidates the various risks. Because a commercial multiple peril policy must in some sense be customized to fit the individual corporation, this line of business

must be handled through agents. Direct writers control only 13.3 percent of the market in commercial multiple peril insurance and only 20.2 percent in fire insurance.

General liability insurance is insurance purchased by businesses or professionals to protect themselves from damage claims made by others. Liability insurance for defective products or facilities is a major part of general liability insurance. This line of insurance was the focus of the 1985-1986 liability insurance crisis (see Chapter 6). For many years, medical malpractice insurance was so insignificant that it was included as part of the general liability line. With the rise in litigation in this area (see Meier and Copeland, 1986), it grew to be a separate line comprising almost 2 percent of property and casualty premiums. General liability insurance is another product that must be tailored to individual needs; 83 percent of general liability insurance is written through agents (Freedman, 1986: 33). Medical malpractice insurance went through a major profit crisis in the early 1970s. As a result of this crisis, many insurance companies abandoned the line; and physician-owned mutual insurance companies entered. These "direct writers" write approximately one-half the medical malpractice insurance in the United States (Freedman, 1986: 139).

The remaining lines of property and casualty insurance are fairly minor. Ocean marine insurance protects goods from loss in ocean transport, while inland marine offers the same protection for other modes of transport. Health and accident insurance is the same insurance offered by life insurance companies to protect individuals from medical bills and accidents. Surety insurance covers the financial guarantees needed by certain professionals who require bonding. Specialized lines for aircraft, glass, boilers, wind damages, and so on continue to exist.

Reinsurance is a small, but extremely important, line of insurance. Insurance companies that insure risks with large potential losses seek to minimize their losses somewhat by spreading the risks. They do this by selling a portion of the insurance underwritten to another insurance company. For example, assume a company has agreed to insure a building for \$500 million. Because the company does not have the assets to pay off such a claim, it might retain the coverage for the first \$100 million for itself and sell coverage on losses of between \$100 to \$500 million to other insurance companies. Reinsurance companies generally specialize in large risks with low probabilities of occurrence. Lloyds of London is perhaps the most famous reinsurance company. Reinsurance is a vital part of the general liability, medical malpractice, commercial multiple peril, ocean marine, and fire insurance lines.

Property and casualty lines can be divided into long- and short-tail lines. A short-tail line of insurance is one where the losses show up quickly after the insurance is issued. A long-tail line of insurance might not produce a

claim for several years after a policy is issued because injured individuals might not immediately realize that they have been harmed (for example, workers exposed to toxic chemicals). Short-tail lines, which include automobile, homeowners, fire, and marine insurance, spend most of their premiums immediately on claims. These companies write a large number of policies and generally have a positive cash flow every year. Long-tail lines often invest premiums for years earning interest before claims come due; general liability, medical malpractice, and reinsurance are long-tail lines. Long-tail lines face less predictable yearly payouts; they often earn a large portion of their income from investments.

The adjusted loss ratios for each line of insurance are also listed in Table 1-10. The adjusted loss ratio is the total claims paid divided by the earned premiums. For short-tail lines, the adjusted loss ratio is a reasonable indicator of financial health (lower ratios indicate more positive cash flow). For long-tail lines, adjusted loss ratios have less meaning because claims paid also include funds set aside in reserves to pay claims that have not yet been made (see Chapter 6).

ASSETS

Because even insurance companies in long-tail lines of property and casualty insurance expect to pay claims sooner than a life insurance company would, the assets acquired by property and casualty companies are substantially less than the assets accumulated by life and health insurance companies. Table 1-11 shows the premium income and the growth of assets for property and casualty companies over time. Property and casualty companies currently have approximately \$311 billion in assets. They earned premiums of \$144 billion in 1985.

The role that property and casualty insurance companies play in the financial markets is, therefore, substantially less than that played by the life and health insurance companies. Still, \$311 billion in assets is not a trivial amount. Historically property and casualty companies had fewer investment restrictions than life insurance companies. Despite the lack of restrictions, property and casualty insurance companies' investments are similar to life and health insurance investments. As Table 1-12 illustrates, property and casualty companies hold more than 60 percent of their assets in government securities; much of that is in tax-free revenue bonds. The major difference between the property and casualty industry and the life industry is the investment in stocks. Without the traditional restrictions that exist in the life insurance industry, and with the need to be more liquid than life insurance companies, property and casualty companies made major investments in

Table 1-11
Property and Casualty Insurance Company Assets and Premiums

<i>Year</i>	<i>Assets (billions)</i>	<i>Premiums^a (millions)</i>
1940	\$5.1	NA
1960	29.4	\$14,972
1970	58.6	32,867
1980	197.7	95,568
1984	264.7	118,166
1985	311.6	144,186

^aPremiums are net premiums written.

Source: Insurance Information Institute, *Insurance Facts*, annual.

Table 1-12
*Percentage Distribution of Property and Casualty
Insurance Company Assets*

<i>Percent of Assets in:</i>	<i>1970</i>	<i>1975</i>	<i>1985</i>
Government Securities	46.0%	53.8%	62.0%
Corporate Bonds	16.8	15.3	12.6
Common Stocks	33.3	26.2	19.2
Preferred Stocks	3.4	4.0	3.8
All Other Investments	.6	.7	2.3

Source: Insurance Information Institute, *Insurance Facts*, annual.

common and preferred stock. Just as life insurance companies' investments change over time to seek higher returns, so do those of property and casualty companies.

INDUSTRY CONCENTRATION

At first glance, the property and casualty industry looks relatively un-concentrated. After all, more than 3,500 insurance companies sell property and casualty insurance. Table 1-13, listing the ten largest property and casualty insurance companies in the United States, appears to confirm this. Although these are large corporations by any measure of the term, the three largest firms have only 18 percent of the market; and the top ten firms have only 39 percent of the market.

Conclusions concerning industry concentration based on Table 1-13 would be misleading, however, because property and casualty insurance is not a single, nationwide market. Many firms offer only a few lines of insur-

Table 1-13
Ten Largest Property and Casualty Insurance Companies

<i>Company</i>	<i>1985 Premiums (millions)</i>
1. State Farm	\$14,096
2. Allstate	7,560
3. Aetna	5,718
4. Nationwide	4,436
5. Liberty Mutual	4,161
6. Travelers	4,140
7. Farmers	4,019
8. CIGNA	3,980
9. Hartford Fire	3,627
10. Continental	3,382

Source: *Best's Review*, 1986.

ance, and most companies are not licensed to sell in insurance in all states. Table 1-14 lists the market percentage controlled by the largest three, five, ten, and twenty firms in each major line of insurance. Individual lines of insurance are far more concentrated than the overall P/C market. The top three firms control approximately one-third of the market in private passenger automobile insurance and homeowners' insurance. The concentration percentages for each line are not much different from the life insurance concentration percentages shown in Table 1-8.

The market concentration figures in Table 1-14 are still underestimates, however, because property and casualty insurance lines do not operate as national markets. Because states regulate and license insurance, markets for many insurance lines are statewide at best. Table 1-15 shows the average

Table 1-14
Market Concentration Figures by Property and Casualty Line 1985

Percent of the Market Controlled by the

<i>Line</i>	<i>Top 3</i>	<i>Top 5</i>	<i>Top 10</i>	<i>Top 20</i>
All Property/Casualty Lines	17.9	24.6	39.1	56.5
Automobile Insurance	28.6	35.4	45.6	57.9
Private Passenger Auto	34.5	41.1	50.5	62.1
Medical Malpractice	29.7	36.9	51.0	68.7
General Liability	22.1	30.7	47.4	66.9
Homeowners'	31.1	36.9	45.7	59.1
Commercial Multiple Peril	19.2	28.0	44.5	63.0

Source: *Best's Review*, 1986.

Table 1-15
*Three Firm Concentration Percentages**

<i>Line</i>	<i>Nationwide Market</i>	<i>Statewide Markets</i>
All Property/Casualty Lines	17.9	25.8
Automobile Insurance	28.6	36.7
Medical Malpractice	29.7	79.1
General Liability	22.1	26.5
Homeowners	31.1	38.6
Commercial Multiple Peril	19.2	26.9

*Percentage of the market held by the three largest firms.

Source: Calculated by the author from *Best's Review*.

three-firm concentration level for six lines of insurance based on 50-state averages. These figures reveal that statewide markets are more concentrated than national market figures would indicate. Especially sensitive to smaller markets are those lines with aggressive direct writers—automobiles, homeowners, and medical malpractice insurance. Of these only medical malpractice, however, is a highly concentrated industry; the three largest companies on the average control 79 percent of the malpractice insurance market.

ENTRY AND EXIT

Barriers to entry in the property and casualty insurance industry do not appear excessive. Although all states place minimum capital and other restrictions on starting a new property and casualty company, between 26 and 72 new insurance companies have been started annually since 1980. Because the 1980s were not particularly good years for property and casualty companies in general, this rate of entry must be considered reasonable. Exit figures reveal the industry's recent economic difficulties. In the past two years, 46 companies have exited each year. More than one-half the exits were involuntary; that is, firms were forced to exit the industry, in most cases by state insurance regulators. Most exiting firms, however, were small insurance companies. Despite the recent increase in exits, in every year, the number of new firms exceeded the number of exiting firms.

PROFITS

The level of insurance industry profits is a highly controversial issue (see Chapter 6). Insurance is governed by different accounting rules so that indus-

Table 1-16
Entry and Exit of Property and Casualty Firms

Year	Total Firms	Retirements	Involuntary	Liquidation	New Firms
1980	3,345	16	6	6	50
1981	3,361	10	2	2	26
1982	3,391	9	3	3	39
1983	3,411	27	7	0	47
1984	3,456	46	27	3	72
1985	3,468	46	26	5	58

Source: *Best's Review*, annual.

try figures may well underestimate profits compared to profits reported by other industries. Only if the profits are based on relatively similar accounting rules can the figures be compared⁶.

One source of reasonably good industrywide profit figures is *Forbes*. *Forbes* publishes an annual estimate of profits in the insurance industry for life insurance firms, property and casualty insurance firms, and diversified insurance firms (that is, firms that sell both types of insurance). Because *Forbes* also provides an average profit figure for all industries, insurance companies can be compared to some standard. Profit estimates for an 11-year period appear in Table 1-17. A simple scan of the data reveals that insurance industry profits are similar to those in other industries. In seven of the 11 years, property and casualty companies and diversified insurance companies

Table 1-17
Profit Figures for the Insurance Industry
(percentage return on equity)

Year	Life Insurance	P/C Insurance	Diversified Insurance	All Industries
1985	11.9	6.4	9.9	12.7
1984	11.9	6.6	11.8	13.4
1983	13.0	12.4	13.3	12.6
1982	11.0	13.3	15.7	12.7
1981	14.9	17.2	14.9	14.7
1980	13.9	21.5	17.8	16.1
1979	15.0	23.0	20.0	16.7
1978	15.0	25.4	20.8	15.4
1977	13.0	21.3	17.2	13.9
1976	12.3	13.3	12.8	12.9
1975	11.9	10.2	6.2	11.7
11-Year Average	13.1	15.5	14.6	13.9

Source: *Forbes*, annual.

had higher profits than the all-industries figures. In three of 11 years, the life insurance industry had higher profits than the all-industries figure.

The average profit figures for this 11-year period are 13.1 percent for life insurance firms,⁷ 15.5 for property and casualty insurance firms, 14.6 percent for diversified firms, and 13.9 percent for the all-industries figure. These averages reveal basically similar long-run profit figures for the insurance industries versus other industries. The one major difference between insurance profits and those of other industries is that insurance industry profits are more variable over time. Particularly in the property and casualty insurance industry, profits fluctuate more than the all-industries' profits because payouts are less predictable.

A second indicator of the insurance industry's financial soundness is stock prices. Since 1975, stock prices for life insurance companies have increased by 278 percent and those for property and casualty companies have increased by 296 percent. These figures compare to the 155 percent increase from 1975 to 1985 in the all stocks index of the New York Stock Exchange.⁸ Surprisingly, aggregate stock prices are unrelated to aggregate profits. The correlation between stock prices and profits for the past ten years is -.25 for the life insurance industry and -.51 for the property and casualty industry.

One final note about insurance industry profits is in order. Often, loss ratios are quoted to indicate that the insurance industry is in dire financial straits. Using the ten-year profit figures for property and casualty figures and the loss ratio figures for this industry, the relationship between loss ratios and profits can be estimated. The adjusted loss ratio is the ratio of claims paid (including loss reserves) divided by premiums earned less dividends paid. When this figure is used as the independent variable in a regression on P/C industry profits (Table 1-18), calculations show that the industry breakeven point is an adjusted loss ratio of 81.06. In other words, at adjusted loss ratios of less than 81, the property and casualty insurance industry is profitable.

The combined ratio is the ratio of claims paid plus loss adjustment expenses plus other business expenses divided by the total premiums earned. This figure does not include investment income. The second regression in Table 1-18 shows that the property and casualty insurance industry is profitable at combined ratios of less than 122.08. Combined ratios greater than 100 are profitable simply because the combined ratio does not include investment income or tax rebates. These breakeven points are for the entire industry. Individual lines will have vastly different breakeven points depending on the expenses involved in processing claims and the amount of investment income. Individual firms can also have different breakeven points for the same reason.

Table 1-18
Relationship between Profits and Insurance Loss Ratios

Adjusted Loss Ratio

Profit =	95.88 - 1.18 (Adjusted Loss Ratio)
$r^2 =$.84
$t =$	6.39
$p =$.0002
$n =$	10
Breakeven point =	81.06

Combined Ratio

Profit =	106.2 - .86 (Combined Ratio)
$r^2 =$.80
$t =$	5.65
$p =$.0005
$n =$	10
Breakeven point =	122.08

Summary

Insurance regulation is a widely ignored segment of political economy. Although insurance directly affects virtually every individual in the United States and although the size of the industry dwarfs that of other industries that are frequently studied, social scientists know little about the politics or economics of insurance. This chapter outlines the structure of the insurance industry in the United States.

Insurance is not a single industry but rather several industries. The general grouping of life and health insurance companies into one industry and property and casualty insurance companies into another must be subdivided yet again. Individual lines of insurance have unique characteristics, and therefore, must be studied separately. Overall, these industries, except for medical malpractice insurance, are only moderately concentrated, barriers to entry and exit are generally low, and profits are good but highly variable.