III

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6

Insurance Companies

LEARNING OBJECTIVES

After reading this chapter, you will understand

- the nature of the business of insurance companies
- the differences between the nature of the liabilities of life insurance companies and those of property and casualty insurance companies
- the different types of life insurance policies
- the different types of property and casualty insurance policies
- the types of assets in which life insurance companies and property casualty insurance companies invest
- the forms of insurance companies: stock and mutual
- the regulation of insurance companies
- recent changes in the insurance business and the factors contributing to those changes

Insurance companies provide (sell and service) insurance policies, which are legally binding contracts for which the policyholder (or owner) pays insurance **premiums.** According to the insurance contract, insurance companies promise to pay specified sums contingent on the occurrence of future events, such as death or an automobile accident. Thus, insurance companies are **risk bearers.** They accept or underwrite the risk in return for an insurance premium.

The major part of the insurance company underwriting process is deciding which applications for insurance they should accept and which ones they should reject, and if they accept, determining how much they should charge for the insurance. This is called the **underwriting process.** For example, an insurance company may not provide life insurance to someone with terminal cancer or automobile insurance to someone with numerous traffic violations. And in some cases, they may provide different classes of insurance with different

premiums. For example, the company may insure but charge a smoker a larger premium for life insurance than a nonsmoker; and insure someone with a mediocre driving record, but charge more for automobile insurance than an individual with a better driving record. The underwriting process is critical to an insurance company.

Because insurance companies collect insurance premiums initially and make payments later *when* (e.g., the insured person's death) or *if* (e.g., an automobile accident) an insured event occurs, insurance companies maintain the initial premiums collected in an investment portfolio, which generates a return. Thus, insurance companies have two sources of income: the initial underwriting income (the insurance premium) and the investment income, which occurs over time. The investment returns result from the investment of the insurance premiums until the funds are paid out on the policy. The premium is a fairly stable type of revenue. Investment returns, however, may vary considerably with the performance of the financial markets.

The payments on the insurance policies are the major expense of the insurance company. These payments vary among the different types of insurance policies and companies. The payments may be very unstable, depending on the type of insurance. Another major type of expense is the operating expense of the insurance company. This expense tends to be quite stable.

Insurance companies' profits, thus, result from the difference between their insurance premiums and investment returns on the one hand, and their operating expense and insurance payments or benefits on the other. The type of risk insured against, which defines the type of premium collected and benefit paid, defines the insurance company. Table 6-1 summarizes the major risks that insurance companies will insure, many of which are elaborated on in this chapter.

Key Points That You Should Understand Before Proceeding

1. Insurance companies bear risk in return for a fee called the premium.
2. Deciding which risks to underwrite and how much to charge for bearing those risks is critical to an insurance company.

TYPES OF INSURANCE

Life Insurance

For life insurance, the risk insured against is the death of the "insured." The life insurance company pays the beneficiary of the life insurance policy in the event of the death of the insured. There are several types of life insurance, which will be examined later in this chapter.

Health Insurance

In the case of health insurance, the risk insured is medical treatment of the insured. The health insurance company pays the insured (or the provider of the medical service) all or a portion of the cost of medical treatment by doctors, hospitals, or others. This type of insurance has undergone significant changes in the past two decades. As a result, there has been a significant restructuring of the health industry, whereby the largest health insurance companies specialize

Table 6-1 Major Risks Insurance Companies Face

LIFE INSURANCE
- Term Insurance
- Whole Life
  - Fixed
  - Variable
- Universal Life
- Second to Die (Survivorship)

OTHER INSURANCE
- Liability
- Umbrella
- Disability
- Long-Term Care

STRUCTURED SETTLEMENTS

INVESTMENT-ORIENTED PRODUCTS
- Guaranteed Investment Contracts (GICs)
- Annuities
  - Fixed
  - Variable
- Mutual Funds

HEALTH INSURANCE
- Medical
  - Indemmity
  - HMO/PPO/etc.
- Dental
- Other

PROPERTY AND CASUALTY
- Property
  - Automobile
  - House
  - Other
- Liability
- Other

MONOLINE INSURANCE

in health insurance rather than sell health insurance in addition to other products, such as life insurance.

Until the past decade, the major type of health insurance available was *indemnity insurance*. According to indemnity insurance, the insurance company agrees to indemnify (reimburse) the insured for covered medical and hospital expenses. That is, the insurance company pays the medical provider (doctor, hospital, etc.) for the medical services provided to the insured. The provider is selected by the insured and can provide whatever service the provider deems appropriate.

Very often there is an annual minimum amount below which the issuer does not pay for the service, but the insured pays (a *deductible*). Typically, there is also a copayment (a "co-pay") required by the insured. For example, the insured pays 20% of the charge for the service and the insurer pays the other 80%.

Due to the lack of constraints and incentives for cost savings, the medical service insured by indemnity insurance became very expensive. In response, various forms of managed health care have been developed. In general, these forms of managed health care put constraints on the choice of the provider (doctor or hospital) by the insured and on the types of service provided by the provider. The various types of managed care, including health maintenance organizations (HMOs), preferred provider organizations (PPOs), and point of service organizations (POSs), are too diverse and complex to be considered here. It is accurate to assert, however, that no widely acceptable method has yet evolved. While

indemnity insurance is still provided on both an individual and group basis, the various forms of *managed care* have become common.

There have been and continue to be nonprofit providers of health insurance, such as Blue Cross and Blue Shield, and federal government providers of health insurance, such as Medicare and Medicaid, as well as for-profit health care providers.

The two major classes of medical expense benefits are

Basic coverage: traditional hospital, surgical, and regular expense coverage; and
Major medical: designed to reduce the financial burden of heavy medical expenses resulting from catastrophic or prolonged illness or injury.

Property and Casualty Insurance

The risk insured by property and casualty (P&C) insurance companies is damage to various types of property. Specifically, it is insurance against financial loss caused by damage, destruction, or loss to property as the result of an identifiable event that is sudden, unexpected, or unusual. The major types of such insurance are

- a house and its contents against risks such as fire, flood, and theft (homeowners insurance and its variants)
- vehicles against collision, theft, and other damage (automobile insurance and its variants)

Liability Insurance

With liability insurance, the risk insured against is litigation, or the risk of lawsuits against the insured due to actions by the insured or others. Liability insurance offers protection against third-party claims, that is, payment is usually made to someone who experiences a loss and who is not a party to the insurance contract, not to the insured.

Umbrella Insurance

Typically, umbrella insurance is pure liability coverage over and above the coverage provided by all the policies beneath it, such as homeowner, automobile, and boat policies. The name *umbrella* refers to the fact that it covers liability claims of all the policies underneath it. In addition to providing liability coverage over the limits of the underlying policies, it provides coverage for claims that are excluded from other liability policies such as invasion of privacy, libel, and false arrest. Typically, users of umbrella policies have a large amount of assets that would be placed at risk in the event of a catastrophic claim.

Disability Insurance

Disability insurance insures against the inability of employed persons to earn an income in either their own occupation ("own occ" disability insurance) or any occupation ("any occ"). Typically, "own occ" disability insurance is written for professionals in white-collar occupations (often physicians and dentists) and "any occ" for blue-collar workers. Another distinction in disability insurance is the sustainability of the policy. Regarding sustainability, there are two types of policies. The first is *guaranteed renewable* (or guaranteed continuable) whereby the issuer has to sustain the policy for the specified period of time and the issuer cannot make any changes in the policy except that it can change the premium rates for the entire class of policy (but not an individual policyholder). The other type is noncancellable

and guaranteed renewable (or simply *noncancellable*), whereby the issuer has no right to make any change in any policy during the specified period. Disability insurance is also divided between short-term disability and long-term disability, with six months being the typical dividing time.

Long-Term Care Insurance

As individuals have been living longer, they have become concerned about outliving their assets and being unable to care for themselves as they age. In addition, custodial care for the aged has become very expensive and is not covered by Medicare. Thus, there has been an increased demand for insurance to provide custodial care for the aged who are no longer able to care for themselves. This care may be provided in either the insured's own residence or a separate custodial facility. Many types of long-term care insurance are available.

Structured Settlements

Structured settlements are fixed, guaranteed periodic payments over a long period of time, typically resulting from a settlement on a disability policy or other type of insurance policy. For example, suppose an individual is hit by an automobile and, as a result, is unable to work for the rest of his or her life. The individual may sue the P&C company for future lost earnings and medical care. To settle the suit, the P&C companies may agree to make specified payments over time to the individual. The P&C company may then purchase a policy from a life insurance company to make the agreed-upon payments.

Investment-Oriented Products

Insurance companies have increasingly sold products that have a significant investment component in addition to their insurance component. The first major investment-oriented product developed by life insurance companies was the **guaranteed investment contract** (GIC). According to a GIC, a life insurance company agrees, in return for a single premium, to pay the principal amount and a predetermined annual crediting rate over the life of the investment, all of which are paid at the maturity date of the GIC. For example, a $10 million five-year GIC with a predetermined crediting rate of 10% means that at the end of five years the insurance company pays the guaranteed crediting rate and the principal. The risk to the customer is that the return of the principal depends on the ability of the life insurance company to satisfy the obligation, just as in any corporate debt obligation. The risk that the insurer faces is that the rate earned on the portfolio of supporting assets is less than the guaranteed rate paid to the customer.

The maturity of a GIC can vary from one year to 20 years. The interest rate guaranteed depends on market conditions and the rating of the life insurance company. The interest rate will be higher than the yield on U.S. Treasury securities of the same maturity. These policies are purchased by individuals and by pension plan sponsors as a pension investment.

A GIC is nothing more than the debt obligation of the life insurance company issuing the contract. The word *guarantee* does not mean that there is a guarantor other than the life insurance company. Effectively, a GIC is a zero coupon bond issued by a life insurance company and, as such, exposes the investor to the same credit risk. This credit risk has been

highlighted by the default of several major issuers of GICs. The two most publicized were Mutual Benefit, a New Jersey–based insurer, and Executive Life, a California-based insurer, which were both seized by regulators in 1991.

Annuity

Another insurance company investment product is an annuity. An annuity is often described as "a mutual fund in an insurance wrapper." (Mutual funds are discussed in Chapter 7.) What does this mean? To answer this question, assume that an insurance company investment manager has two identical common stock portfolios, one in a mutual fund and the other in an annuity. On the mutual fund, all income (that is, the dividend) is taxable, and the capital gains (or losses) realized by the fund are also taxable, although at potentially different tax rates. The income and realized gains are taxable whether they are withdrawn by the mutual fund holder or reinvested in the fund. There are no guarantees associated with the mutual fund; its performance depends solely on the portfolio performance.

Because of the insurance wrapper, discussed below, the annuity is treated as an insurance product and as a result receives a preferential tax treatment. Specifically, the income and realized gains are not taxable if not withdrawn from the annuity product. Thus, the "inside buildup" of returns is not taxable on an annuity, as it is also not on other cash value insurance products. At the time of withdrawal, however, all the gains are taxed at ordinary income rates.

The "insurance wrapper" on the mutual fund that makes it an annuity can be of various forms. The most common "wrapper" is the guarantee by the insurance company that the annuity policyholder will get back no less than the amount invested in the annuity (there may also be a minimum period before withdrawal to get this benefit). Thus, if an investor invests $100 in a common stock–based annuity and at the time of withdrawal (or at the time of death of the annuity holder) the annuity has a value of only $95, the insurance company will pay the annuity holder (or its beneficiary) $100. Many other types of protection or insurance features have also been developed.

Of course, insurance companies impose a charge for this insurance benefit—an insurance premium for the insurance component of the annuity. Thus, while mutual funds have an expense fee imposed on the fund's performance, an annuity has a *mortality and expense (M&E) fee* imposed. Annuities are, therefore, more expensive to the investor than mutual funds. In return, annuity policyholders get the insurance wrapper, which provides the tax benefit. Annuities can be either fixed annuities, similar to GICs, or variable annuities whose performance is based on the return of a common stock or bond portfolio.

Mutual funds and annuities distributed by insurance companies may have their investments managed by the insurance company investment department or by external investment managers, as discussed in the next section.

Key Points That You Should Understand Before Proceeding

1. Life, property/casualty, and health are among the important categories of risks that insurance companies specialize in.
2. Insurance companies also sell investment products such as GICs (which are essentially zero coupon bonds) and annuities ("mutual funds in an insurance wrapper").

Monoline Insurance Companies

A very different type of insurance is monoline insurance. Monoline insurers guarantee the timely repayment of the bond principal and interest when a bond insurer defaults on these payments. Monoline insurers are called "monoline" because they provide their insurance services to only one industry, the capital markets. The insured securities have traditionally been municipal bonds, but they now include structured finance bonds, collateralized debt obligations (CDOs), collateralized loan obligations (CLO), asset-backed bonds, and other related products that we describe in later chapters in this book.

Monoline insurance companies make debt service payments on these bonds when the issuers cannot. Multiline insurance companies, on the other hand, often require a lengthy claims and submission and adjustment process.

Monoline insurance has existed since the 1970s. Ambac Financial Group Inc. began in 1971 and MBIA Inc. (previously the Municipal Bond Insurance Association) began in 1973. The Capital Markets Assurance Corporation was founded in 1987 primarily to insure asset-backed securities. In late 2007, Warren Buffett's Berkshire Hathaway Assurance entered the monoline insurance business for municipal bonds only. This entry was intended to capitalize on the subprime loan crisis, which is discussed in Chapter 23.

Monoline insurers have been rated AAA and must have this high rating to be effective since they transfer their rating to the bond issue being insured. The insurers collect an insurance fee from issuers for providing insurance on their bonds; this insurance allows the bond issues to be rated AAA. The issuer then saves financing costs by issuing a AAA rated bond instead of a bond with their own lower rating. This savings exceeds the fee they pay for the insurance, providing a gain to the issuer. The monoline insurer insures many different bonds and by this diversification reduces the risk and the total cost of insuring these bonds.

Bond insurance has become an integral part of the capital markets, particularly in the municipal market wherein historically approximately one-half of municipal bonds have been insured.

INSURANCE COMPANIES VERSUS TYPES OF PRODUCTS

Whereas in concept these various types of insurance could be combined in different ways in actual companies, traditionally they have been packaged in companies in similar ways. Traditionally, life insurance and health insurance have occurred together in a *life and health insurance company* (L&H company). And property and casualty insurance have been combined in a P&C insurance company. Companies that provide insurance in both insurance products are called **multiline insurance companies**. Investment products tend to be sold by life insurance companies, not P&C companies. Tables 6-2 and 6-3 provide the 10 largest life insurance companies and P&C companies, respectively.

There have been some recent changes in the combinations of products by type of company, however. Health insurance has predominately, but not completely, separated from life insurance and become a separate industry. This change has been due mainly to federal regulation of the health insurance industry. Life insurance companies have also increasingly offered investment-oriented products, both annuities, variable and fixed, and mutual funds. Disability insurance is now sold primarily by pure disability companies but is also offered by some life insurance companies. Long-term care insurance is a fairly new line of

Table 6-2 Top 10 U.S. Life Insurance Companies

Company	12/31/07 Invested Assets ($000s)
1. Metropolitan Life Insurance Company	209,923,708
2. Teachers Insurance and Annuity Association of America	174,435,318
3. Prudential Insurance Company of America	148,745,800
4. Northwestern Mutual Life Insurance	131,563,104
5. New York Life Insurance Company	104,765,167
6. Massachusetts Mutual Life Insurance	74,280,405
7. American Life Insurance Company	62,806,167
8. Lincoln National Life Insurance	60,611,954
9. Principal Life Insurance Company	58,440,982
10. Allstate Life Insurance Company	56,871,650

Source: *ALIRT Insurance Research, LLC.*

Table 6-3 Top 10 U.S. Property & Casualty Insurance Companies

Company	12/31/07 Invested Assets ($000s)
1. State Farm Mutual Auto Insurance Company	99,103,876
2. National Indemnity Company	71,769,233
3. Allstate Insurance Company	39,953,260
4. Continental Casualty Company	34,431,958
5. Liberty Mutual Insurance Company	29,368,315
6. National Union Fire Insurance Company of Pittsburgh	27,710,067
7. Federal Insurance Company	26,690,512
8. Zurich American Insurance Company	24,244,071
9. State Farm Fire and Casualty Company	23,782,417
10. Nationwide 3Mutual Insurance Company	23,036,571

Source: *ALIRT Insurance Research, LLC.*

business and is offered by different types of companies, but mainly life insurance companies. In terms of specific product offerings, most companies are unique with respect to the combination of products they offer and how they offer them.

Key Points That You Should Understand Before Proceeding

1. Traditionally, L&H insurers have been distinct from P&C insurers. A few multiline insurers provide both types of insurance.
2. Increasingly, among L&H insurers, life, health, and disability insurance are being provided by separate companies.

FUNDAMENTALS OF THE INSURANCE INDUSTRY

A fundamental aspect of the insurance industry results from the relationship between revenues and costs. A bread manufacturer purchases its ingredients, uses these ingredients to make bread, and then sells the bread, all over a fairly short time frame. Therefore, the bread manufacturer's profit margin is easily calculated.

An insurance company, on the other hand, collects its premium income initially and invests these receipts in its portfolio. The payments on the insurance policy may occur much later and, depending on the type of insurance, may occur in a very unpredictable manner. Consequently, the payments are contingent on potential future events. For example, with respect to life insurance, it is certain that everyone will die. However, it is not known when any individual will die. The timing of the payment on any specific life insurance policy is, thus, uncertain. Although the payments on any single life insurance policy is uncertain, statisticians or actuaries can predict the pattern of deaths on a large portfolio of life insurance policies. Thus, while the payment on a single life insurance policy is uncertain, statistically the payment pattern on a portfolio of life insurance policies is less uncertain. And for a large portfolio of life insurance policies, the individual deaths are uncorrelated. At the other extreme, whereas payments on home insurance against hurricanes are singularly uncertain, the payments on a portfolio of homes are also uncertain. And payments on hurricane insurance are correlated with each other. If one house in South Florida is destroyed by a hurricane, for example, it is likely that many others will also be destroyed.

Thus, there are two very important differences between calculating profitability of bread manufacturers and insurance companies. The first is that the timing and magnitude of the payments are much less certain for an insurance company. The second is that there is a long lag between the receipts and payments for an insurance company, which introduces the importance of the investment portfolio.

These differences in the providers of bread and insurance lead to differences in the way consumers of bread and insurance view their providers. Purchasers of bread are not harmed if the bread manufacturer goes bankrupt the day after they buy the bread. However, while the purchaser of bread receives the bread immediately, the purchaser of insurance receives the payment on his or her insurance policy in the future and, thus, must be concerned about the continued viability of the insurance company. Therefore, the credit rating of an insurance company is important to a purchaser of insurance, especially for the types of insurance that may be paid well into the future, such as life insurance.

Key Points That You Should Understand Before Proceeding

1. The timing and magnitude of payouts to policyholders are highly uncertain for an insurance company.
2. Due to the lag between the premium receipts and policy payouts, the return on the investment portfolio is critical to an insurance company's profitability.

REGULATION OF THE INSURANCE INDUSTRY

According to the McCarran Ferguson Act of 1945, the insurance industry is regulated by the individual states, not the federal government. However, there has been increasing discussion of federal regulation. Insurance companies whose stock is publicly traded are also regulated by the Securities and Exchange Commission (SEC).

Model laws and regulations are developed by the National Association of Insurance Commissioners (NAIC), a voluntary association of state insurance commissioners, for application to insurance companies in all states. Although the adoption of a model law or regulation by the NAIC is not binding on any state, states typically use these as a model when writing their own laws and regulations.

Insurance companies may also be rated by the rating agencies (Moody's, Standard & Poor's, A.M. Best, Fitch, and others) for both their "claims paying ability" and their debt outstanding, if any. Public insurance companies (discussed below) are also evaluated by equity analysts who work at investment banks and brokers or dealers, with respect to the attractiveness of their outstanding common stock.

The relationship between the premium revenues and the eventual contingent contractual insurance policy payments affects an important aspect of evaluating insurance companies. Insurance companies are monitored by their accountants and auditors, their rating agencies, and their government regulators. These monitors of the insurance companies are concerned about the financial stability of the insurance companies due, among other issues, to the lack of synchronicity between premiums and insurance policy payments and also the volatility of the payments. To assure financial stability, these monitors require insurance companies to maintain reserves or surplus, which are the excess of assets over liabilities. These reserves or surpluses are defined differently by regulators and accountants and have different names. Because for regulatory purposes, the treatment of both assets and liabilities is established by the state statutes covering the insurance company, surplus, by this measure, is called statutory surplus (or reserves) or STAT surplus. Generally accepted accounting principles (GAAP) surplus (or reserves) are defined by accountants for their purposes. While statutory and GAAP reserves are measured differently, their purposes are similar, although not identical.

Although specifying the definition of the assets is straightforward, defining liabilities is difficult. The complication in determining the value of liabilities arises because the insurance company has committed to make payments at some time in the future, and those payments are recorded as contingent liabilities on its financial statement. The reserves are simply an accounting entry, not an identifiable portfolio.

Statutory surplus is important because regulators view this as the ultimate amount that can be drawn upon to pay policyholders. The growth of this surplus for an insurance company also determines how much future business it can underwrite.

Key Points That You Should Understand Before Proceeding

1. Insurance companies are regulated by the individual states, typically using the laws developed by the NAIC as a model. They may also be rated by debt rating agencies.
2. Insurance companies whose stock is publicly traded are also regulated by the SEC, and perhaps evaluated by equity analysts.
3. The surplus (i.e., the excess of assets over liabilities) of an insurance company is measured differently for statutory and GAAP purposes, and is an important indicator of its financial standing.

STRUCTURE OF INSURANCE COMPANIES

Based on the previous discussion, insurance companies are really a composite of three companies. First, there is the "home office" or actual insurance company. This company designs the insurance contract ("manufactures" the contract) and provides the backing for the financial guarantees on the contract, that is, assures the policyholder that the contract will pay off under the conditions of the contract. This company is called the *manufacturer* and *guarantor* of the insurance policy. Second, there is the investment component that invests the premiums collected in the investment portfolio. This is the *investment company.*

The third element of an insurance company is the *distribution component* or the sales force. There are different types of distribution forces. First, there are the *agents* who are associated with the company. Agents sell only or mainly the company's own manufactured products. These agents typically are not employees of the company (although some companies also use employees as salespeople), but entrepreneurs financially associated with the company. There are also *brokers* who are not associated with any company but sell the insurance products of many companies. Brokers have traditionally operated individually but are increasingly operating in groups called *producer groups.* As deregulation progresses, commercial banks have also become a natural means of distribution for insurance and investment products. Banks are averse to "manufacturing" insurance products because of their inexperience; the risk borne by manufacturing insurance products; and the long payback period of some insurance products. On the other hand, insurance companies are attracted by commercial bank customer contacts. As a result, commercial bank distribution of insurance company products has grown considerably. This relationship is called bankassurance. More recently, the Internet has also been used by some insurance companies to distribute insurance products directly to clients. Internet distribution is very new and has considerable potential but is still in its infancy. This mode of distribution has been most successful in the more commodity-like insurance products, such as term life insurance and automobile insurance.

These three components of insurance companies traditionally have been combined in one overall company, but they are increasingly being separated and the three functions are being provided by different companies. First, as previously mentioned, many insurance companies use independent brokers or producer groups to distribute their products rather than their own agents. Many companies no longer have their own agents and sell all their products exclusively through brokers, producer groups, or on the Internet. Second, insurance companies are increasingly outsourcing parts of their investment portfolio or even the entire portfolio to external independent investment managers. Investment managers are also increasingly diversifying, that is, not specializing in managing any one type of assets such as pension fund assets, mutual funds, or insurance company assets, but managing several or all of them, including insurance company assets. Third, while the home office component of an insurance company seems to be the core of the insurance company, some home offices use external actuarial firms to design their contracts. And, more importantly, they may *reinsure* some or all of the liabilities they incur in providing insurance. According to the reinsurance transaction, the initial insurer transfers the risk of the insurance to another company, the **reinsurer.** There is an industry of reinsurers who accept the risk incurred by the primary insurance company. The financial guarantee on the insurance policy is, thus, provided by the reinsurer rather than the insurance company that originally provided or "wrote" the policy.

Given this fragmentation of functions in an insurance company, there has been discussion of a "virtual insurance company," whereby a small group of executives in the home office have external actuarial firms design the contract; reinsure all the insurance policies written; outsource all the investments; and use brokers to distribute their products. Some insurance companies are currently approaching being a virtual insurance company.

Key Points That You Should Understand Before Proceeding

1. The three key components of an insurance company are the design and financial guarantee of the insurance contract; the distribution of the product; and the investment of the premiums collected.
2. Traditionally, these components have been combined in a single company, but increasingly separate companies are performing these functions.

FORMS OF INSURANCE COMPANIES: STOCK AND MUTUAL

There are two major forms of life insurance companies: stock and mutual. A **stock insurance company** is similar in structure to any corporation or public company. Shares (of ownership) are owned by independent shareholders and are traded publicly. The shareholders care only about the performance of their shares, that is, the stock appreciation and the dividends. Their holding period and, thus, their view may be short term. The insurance policies are simply the products or business of the company.

In contrast, **mutual insurance companies** have no stock and no external owners. Their policyholders are also their owners. The owners, that is, the policyholders, care primarily or even solely about the performance on their insurance policies, notably the company's ability to pay on the policy. Since these payments may occur considerably into the future, the policyholders' view may be long term. Thus, while stock insurance companies have two constituencies, their stockholders and their policyholders, mutual insurance companies only have one, since their policyholders and their owners are the same. Traditionally the largest insurers have been mutual, but recently there have been many *demutualizations*, that is, conversions by mutual companies to stock companies.

The debate on which is the better form of insurance company, stock or mutual, is too involved to be considered in any depth here. However, consider selected comments on this issue. First, consider this issue from the perspective of the policyholder or perhaps the rating agency or regulator, not from the point of view of the insurance company. Mutual holding companies have only one constituency, their policyholder or owner. The liabilities of many types of insurance companies are long term, especially the writers of life insurance. Thus, mutual insurance companies can appropriately have a long time horizon in their strategies and policies. They do not have to make short-term decisions to benefit their shareholders, whose interests are usually short term, via an increase in the stock price or dividend, in a way that might reduce their long-term profitability or the financial strength of the insurance company. In addition, if the insurance company makes profits it can pass them on to its policyholders via reduced premiums. (Policies that benefit from an increased profitability of the insurance company are called *participating policies*, as discussed in the following text.) These increased profits do not have to accrue to stockholders because there are none.

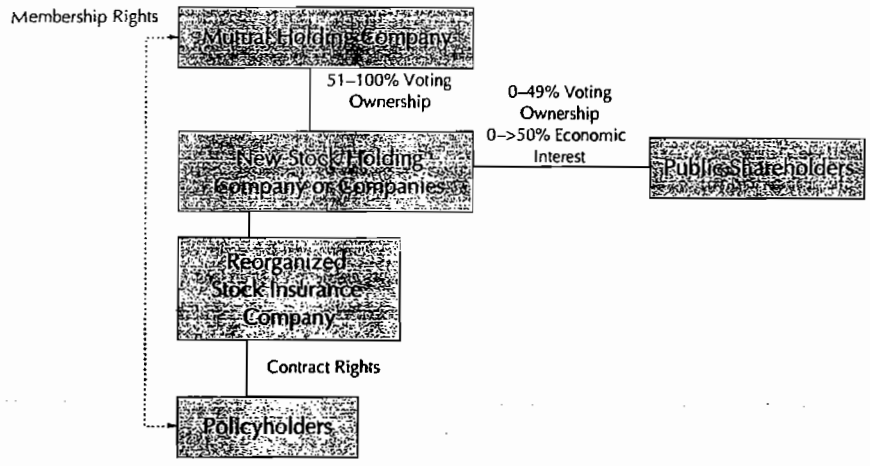
Finally, mutual insurance companies can adopt a longer time frame in their investments, which will most likely make possible a higher long-term return. Mutual insurance companies, for example, hold more common stock in their investment portfolios. However, whereas the long time frame of mutual insurance companies may be construed as an advantage over stock companies, it can also be construed as a disadvantage. Rating agencies and others assert that, due to their longer horizon, mutual insurance companies may be less efficient and have higher expenses than stock companies. Empirically, rating agencies and others assert that mutual insurance companies typically have reduced their expenses after converting to stock companies. Overall, it can be argued that mutual insurance companies have such long planning horizons that they may not operate efficiently, particularly with respect to expenses. Stock companies, on the other hand, have very short planning horizons and may operate to the long-term disadvantage of their policyholders to satisfy their stockholders in the short run.

Consider now the issue of stock versus mutual companies from the perspective of the insurance company. What have been the motivations of mutual insurance companies to go public (issue stock via an initial public offering [IPO]) in recent years? Several reasons are typically given. First, with the financial industry diversifying, consolidating, and growing, insurance companies have concluded that they need to acquire other financial companies (insurance companies, investment companies, and other financial companies) to prosper or even survive. To conduct these acquisitions they have to have capital. Mutual companies cannot, by definition, issue stock and are limited in the amount of public debt they can issue—mutual insurance companies issue public debt via "surplus notes." In addition, internal surplus has been growing slowly for the insurance industry. Thus, many insurance companies have concluded that to expand as quickly as they deem essential, they have to be able to raise equity capital and, thus, go public. Second, some mutual insurance companies and their advisors believe that, at least at some times, stock is a better "acquisition currency" than cash (typically for reasons of taxes and financial accounting), even if the mutual insurance company has enough cash for the acquisition. Finally, company stock and stock options have become a more important form of incentive compensation in many industries, and many insurance companies have concluded that to attract, retain, and motivate the desired executives, they need public stock in their companies.

Whereas many mutual insurance companies go public for these reasons, other mutual insurance companies continue to prosper as mutuals. And while stock insurance companies can raise capital to acquire other companies, they also become vulnerable to being acquired by other companies. Mutual companies cannot be involuntarily acquired.

A new form of insurance company, which is a hybrid between a pure mutual and a pure stock company, has been approved by some states and implemented by some insurance companies in these states since their introduction in 1996. This form is called a **mutual holding company (MHC)**. According to the MHC structure, the upstream holding company is a mutual company (that is, there is no stockholder ownership) and also a holding company (that is, a mutual holding company but not an insurance company). Under the MHC structure, the mutual company forms a stock subsidiary and contributes some or all of its operating businesses to the subsidiary. Policyholders retain membership rights in the mutual holding company and contractual rights in the operating subsidiary. Up to 49.9% of the subsidiary's voting interest can be sold to the public to raise primary capital. The mutual holding company continues to hold a majority ownership in the downstream insurance company. The structure of an MHC is shown in Figure 6-1.

Figure 6-1 Mutual Holding Company—Corporate Structure



The participating life insurance is written by the downstream public life insurance company. Since the MHC board of directors has majority ownership of the life insurance company, it can and legally must operate the company in the best interests of the participating policyholders. Among the advantages of the MHC are

access to external funds, including equity
creation of acquisition currency, that is, common stock (which may be superior to cash for acquisitions)
expansion into new nonparticipating lines of business with these funds
retention of majority control of an insurance company
management ownership provides incentives to attract and retain top management

There are also tax advantages to a mutual insurance company becoming an MHC.

MHC laws have been approved by only a few states, and even where approved, the laws vary widely by state. The experience with MHCs is not yet sufficient to assess whether this form will be a viable and growing form of life insurance company structure. In fact, the Principal Financial Group, which converted from a mutual to an MHC during 1998, converted to a stock company.

Key Points That You Should Understand Before Proceeding

1. In terms of ownership, there are two main forms of insurance companies: stock and mutual. A hybrid form, the mutual holding company, has been approved in some states.
2. Traditionally, insurance companies have been mutual, but they are increasingly demutualizing due to the perceived benefits of having a publicly traded stock.

INDIVIDUAL VERSUS GROUP INSURANCE

All the insurance products mentioned in this chapter are sold to individuals. Some insurance products are also sold to groups, typically to the employees of specific companies through their employers, or educational, medical, or other professional associations. Among the major types of products distributed to groups are term life insurance, whole life insurance, medical insurance, disability insurance (short-term and long-term), and investment products such as mutual funds, annuities, and 401(k) products.

Insurance companies often have different distribution systems for individual and group products. They are typically different because individual product distributors deal with individuals and small company owners, and group product distributors deal with human resource departments of corporations and other organizations. In the P&C business, there is also a similar distinction between *personal lines of business* and *commercial lines of business*. Some P&C companies focus mainly or solely on personal lines such as automobile and homeowners insurance; others focus on commercial lines such as business property and liability insurance.

Key Point That You Should Understand Before Proceeding

1. Insurance products may be sold either to individuals (e.g., life, automobile) or to groups (e.g., disability, business property).

TYPES OF LIFE INSURANCE

This section elaborates on the types of life insurance products introduced earlier. There are two fundamentally different types of life insurance: term life insurance and cash value life insurance.

Term Insurance

Term insurance is *pure life insurance*. If the insured dies while the policy is intact, the beneficiary of the policy receives the death benefit. If the insured does not die within the period, the policy is invalid and has no value. There is no cash value or investment value for a term insurance policy. In addition, the policyholder cannot borrow against the policy.

With respect to the premium paid, there are two different types of term policies. The first is *level term*. For this type, the premium is constant over the life of the policy. For example, for a 10-year term policy, the premium will be the same for each of the 10 years. Obviously, given the increasing probability of dying with age, the insured overpays early in the life of the policy and underpays late in the policy's life. The second type is *annual renewable term*, whereby the policy provides guaranteed protection over the term of the policy (e.g., 10 years), but at an increasing premium. However, a maximum premium schedule is provided.

Cash Value or Permanent Life Insurance

There is a broad classification of life insurance, which is cash value or permanent or investment-type life insurance. A common type of cash value life insurance is called whole life insurance. In addition to providing pure life insurance (as does term insurance), whole life

insurance builds up a cash value or investment value inside the policy. This cash value can be withdrawn and can also be borrowed against by the owner of the policy. Or, if the owner wishes to let the policy lapse, he or she can withdraw the cash value. This cash value develops because of the level premium approach to paying for this type of insurance. The actuarial cost of pure insurance increases with age, but the premium charged on this type of insurance is level. The policyholder is therefore overpaying for insurance early in the life of the policy and underpaying thereafter. The cash value builds up in the policy both for this reason and because the premium is greater than the premium for level term insurance. Growth in the cash value of the life insurance policy is referred to as the "inside buildup." A major advantage of this and other types of life insurance that have a cash or investment value is that *the inside buildup is not subject to taxation*, that is, not taxed as either income or capital gains. Neither is the beneficiary of the death benefit of a life insurance policy subject to an income tax. The death benefit of the policy may or may not be subject to estate tax, depending on how the beneficiary status is structured. Consequently, life insurance products have considerable tax advantages.

Life insurance and life insurance products are very complex. Only an overview is provided in this chapter.[1] There are two categories with respect to cash value life insurance policies. The first is whether the cash value is *guaranteed* or *variable*. The second is whether the required premium payment is *fixed* or *flexible*. Thus, there are four combinations (see Table 6-4), which we discuss below.

Guaranteed Cash Value Life Insurance

Traditional cash value life insurance, usually called whole life insurance, has a guaranteed buildup of cash value based on the general account portfolio of the insurance company. The insurance company guarantees a minimum cash value at the end of each year. This guaranteed cash value is based on a minimum dividend paid on the policy. In addition, the policy can be either *participating* or *nonparticipating*. For nonparticipating policies, the minimum dividend and the minimum cash value on the policy are the guaranteed amounts; that is, there is no upside. For the participating policy, the dividend paid on the policy is based on the realized actuarial experience of the company and its investment portfolio. The cash value may be above but not below the guaranteed level for participating policies. Thus, the actual performance of the policy may be substantially affected by the actual policy dividends over the guaranteed amount.

Table 6-4 Classification of Cash Value Insurance

	Guaranteed Dollar Cash Value Policies	Variable/Non-Guaranteed Policies
Fixed Premium	Whole life insurance	Variable life insurance
Flexible Premium	Universal life insurance	Variable universal life insurance

[1] For an excellent treatment of life insurance, see Ben G. Baldwin, *The New Life Insurance Investment Advisor*, revised edition (Boston, MA: McGraw Hill, 1994). See also *Life Insurance Fact Book*, American Council of Life Insurance, 2007.

Variable Life Insurance

Contrary to the guaranteed or fixed cash value policies based on the general account portfolio of the insurance company, variable life insurance policies allow the policyowners to allocate their premium payments to and among separate investment accounts maintained by the insurance company, within limits, and also to be able to shift the policy cash value among the separate accounts. As a result, the amount of the policy cash value and the death benefits depend on the investment results of the separate accounts the policyowners have selected. Thus, there is no guaranteed cash value or death benefit. Both depend on the performance of the selected investment portfolio.

The types of separate account investment options offered vary by insurance companies. Typically, the insurance company offers a selection of common stock and bond fund investment opportunities, often managed by the company itself and other investment managers. If the investment options perform well, the cash value buildup in the policy will be significant. However, if the policyholder selects investment options that perform poorly, the variable life insurance policy will perform poorly. There could be little or no cash value buildup, or, in the worst case, the policy could be terminated. This type of life insurance is called **variable life insurance**. Variable life insurance, which typically has common stock investment options, grew quickly beginning with the stock market rally of the late 1990s, but declined during the early 2000s.

Flexible Premium Policies—Universal Life

The key element of **universal life** is the flexibility of the premium for the policyowner. This flexible premium concept separates pure insurance protection (term insurance) from the investment (cash value) element of the policy. The policy cash value is set up as the cash value fund (or accumulation fund) to which the investment income is credited and from which the cost of term insurance for the insured (the mortality charge) is debited. The expenses are also debited.

This separation of the cash value from the pure insurance is called the "unbundling" of the traditional life insurance policy. Premium payments for universal life are at the discretion of the policyholder—that is, are flexible—except that there must be a minimum initial premium to begin the coverage. There must also be at least enough cash value in the policy each month to cover the mortality charge and other expenses. If not, the policy will lapse. Both guaranteed cash value and variable life can be written on a flexible premium or fixed premium basis, as summarized in Table 6-4.

Variable Universal Life Insurance

Variable universal life insurance combines the features of variable life and universal life policies, that is, the choice of separate account investment products and flexible premiums. Since the 1990s, term and variable universal life insurance have been growing at the expense of whole life insurance.

Survivorship (Second to Die) Insurance

Most whole life insurance policies are designed to pay death benefits when the person specified insured dies. An added dimension of whole life policies is that two people (usually a married couple) are jointly insured and the policy pays the death benefit not when the first person dies, but when the second person (the "surviving spouse") dies. This is called

survivorship insurance or *second-to-die insurance.* This survivorship feature can be added to standard cash value whole life, universal life, variable life, and variable universal life policies. Thus, each of the four policies listed in Table 6-4 could also be written on a survivorship basis.

In general, the annual premium for a survivorship insurance policy is lower than for a policy on a single person because, by construction, the second of two people to die has a longer life span than the first. Survivorship insurance is typically sold for estate planning purposes.

Key Points That You Should Understand Before Proceeding

1. There are two key types of life insurance: term insurance, which does not have investment value; and cash value life insurance, which has investment value and can be borrowed against.
2. Cash value insurance products may be "guaranteed" or "variable"; with fixed or flexible premiums; and with or without a survivorship feature.

GENERAL ACCOUNT AND SEPARATE ACCOUNT PRODUCTS

The *general account of an insurance company* refers to the investment portfolio of the overall company. Products "written by the company itself" are said to have a "general account guarantee," that is, they are a liability of the insurance company. When the rating agencies (Moody's, Standard & Poor's, A.M. Best, and Fitch) provide a credit rating (discussed in Chapter 20), it is on products written by or guaranteed by the general account. Such ratings are on the "claims-paying ability" of the company. Typical products written by and guaranteed by the general account are whole life, universal life, and fixed annuities (including GICs). Insurance companies must support the guaranteed performance of their general account products to the extent of their solvency. These are called **general account products.**

Other types of insurance products receive no guarantee from the insurance company's general account, and their performance is not based on the performance of the insurance company's general account but solely on the performance of an account separate from the general account of the insurance company, often an account selected by the policyholder. These products are called **separate account products.** Variable life insurance and variable annuities are separate account products. The policyholder chooses specific portfolios to support these products. The performance of the insurance product depends almost solely on the performance of the portfolio selected, adjusted for the fees or expenses of the insuring company (which do depend on the insurance company).

Key Points That You Should Understand Before Proceeding

1. The overall investment portfolio of an insurance company supports its general account products.
2. Separate account products depend solely on the performance of an account chosen by the policyholder.

PARTICIPATING POLICIES

The performance of separate account products depends on the performance of the separate account portfolio chosen and is not affected by the performance of the overall insurance company's general account portfolio. In addition, the performance of some general account products is not affected by the performance of the general account portfolio. For example, disability income insurance policies may be written on a general account, and while their payoff depends on the solvency of the general account, the policy performance (for example, its premium) may not participate in the investment performance of the insurance companies' general account investment portfolio.

Other general account insurance products *participate* in the performance of the company's general account performance. For example, whereas a life insurance company provides the guarantee of a minimum dividend on its whole life policies, the policies' actual dividend may increase if the investment portfolio performs well. (This is called the "interest component" of the dividend: The other two components are the M&E components discussed previously.) Thus, the performance of the insurance policy participates in the overall company's performance. Such a policy is called a ***participating policy***, in this case, a participating whole life insurance policy.

Both stock and mutual insurance companies write both general and separate account products. However, most participating general account products are written in mutual companies.

Key Points That You Should Understand Before Proceeding

1. A participating policy pays a higher dividend than the guaranteed minimum if the general account portfolio performs well.
2. General account products may also be nonparticipating, with fixed payoffs.

INSURANCE COMPANY INVESTMENT STRATEGIES[2]

In general, the characteristics of insurance company investment portfolios should reflect their liabilities, that is, the insurance products they underwrite.

There are many differences among the various types of insurance policies. Among them are the following:

- the expected time at which the average payment will be made by the insurance company (technically, the "duration" of the payments)
- the statistical or actuarial accuracy of estimates of *when* the event insured against will occur and the *amount* of the payment (that is, the overall risk of the policy)
- other factors

In addition, there are tax differences among different types of insurance policies and companies.

The key distinction between life insurance and property and casualty insurance companies lies in the difficulty of projecting whether or not a policyholder will be paid off and how much the payment will be. Although this is no easy task for either a life or a P&C

[2] For a more detailed discussion of investment strategies, see Frank J. Jones, "An Overview of Institutional Fixed Income Strategies," in Volume 1 of *Professional Perspectives on Fixed Income Portfolio Management* (Hoboken, NJ: John Wiley & Sons, 2000), pp. 1–13.

insurance company, it is easier from an actuarial perspective for a life insurance company. The amount and timing of claims on property and casualty insurance companies are more difficult to predict because of the randomness of natural catastrophes and the unpredictability of court awards in liability cases. This uncertainty about the timing and amount of cash outlays to satisfy claims has an impact on the investment strategies of the funds of property and casualty insurance companies compared to life insurance companies.

Without investigating the details for the differences in the portfolios of different types of insurance products, the major differences in the portfolios of life companies and P&C companies are as follows. Life companies on average have less common stock, more private placements, more commercial mortgages, less municipal bonds, and longer maturity bonds. (These securities and financial assets are discussed in later chapters.) The difference in municipal bond holdings is due to the tax-exempt characteristic of these securities. The larger holdings of private placements and commercial mortgages indicate the yield orientation of life companies. This yield orientation is also consistent with the low holding of common stock for life insurance companies.

There are also differences in investment strategy between public (or stock) and mutual insurance companies of the same type. The major difference is that stock companies tend to have less common stock than mutual companies. The major reason for this difference is that common stock analysts, who make buy-hold-sell recommendations on all public companies for institutional and individual investors, consider mainly regularly recurring operating income in their calculation of income, not volatile returns. Coupon and dividend income tend to be stable, and capital gains tend to be unstable. Thus, these analysts have a bias favoring bonds, which have higher interest income, over stocks, which have higher capital gains and, over the long term, higher total returns. As a result, mutual insurance companies, which are not rated by common stock analysts, can focus on total return rather than just yield and have more common stock than public companies.

CHANGES IN THE INSURANCE INDUSTRY

There have been three major types of changes in the insurance industry in the past two decades:

- the deregulation of the financial system
- internationalization of the insurance industry
- demutualization

We discuss each of these changes in the following text.

The Deregulation of the Financial System

In 1933, Congress passed the Glass-Steagall Act (discussed in Chapter 2). The act separated commercial banking, investment banking, and insurance. That is, a company could be involved in only one of these three types of business. One of the major intentions of this act was to prevent a single organization from having complete control over the sources of corporate funding, specifically lending to and underwriting the securities of a company. An initial celebrated outcome of this Act, which went into effect in 1935, was the breakup of the "House of Morgan," the business of J.P. Morgan. A Morgan son, two Morgan partners, and 25 employees left J.P. Morgan to set up the investment bank, Morgan Stanley. (J.P. Morgan subsequently became Morgan Guaranty Trust Company when it merged with the much larger Guaranty Trust Company in 1959.) Both the bank and the investment

bank continue, although in significantly changed forms. J.P. Morgan was acquired by Chase Manhattan in July 2000 and has since been called J.P. Morgan Chase.

Over time, due to the evolution of the financial system, the implementation of the Glass-Steagall Act became more ambiguous, more difficult to implement, and, in the view of many, counterproductive. With this background, a recent landmark financial event was the revocation of the Glass-Steagall Act. On November 12, 1999, the Gramm-Leach-Bliley Act (GLB), called the Financial Modernization Act of 1999, was signed into law. This act removed the 50-year-old "anti-affiliation restrictions" among commercial banks, investment banks, and insurance companies.

The GLB has facilitated and accelerated affiliations among these three types of institutions. The first mega-institution of this type is the combination of Salomon Brothers and Smith Barney, both investment banks; Travelers, an insurance company; and Citicorp, a commercial bank. This combined firm was founded in 1998 when Citigroup and Travelers merged, called simply Citigroup, and was involved in insurance, commercial banking, investment banking, and security brokerage. However, the synergies between insurance and banking did not work out well and in August 2002, Citigroup spun off Travelers as a separate subsidiary and three years later sold Travelers to Met Life. No companies have since attempted to combine insurance and banking on a large scale.

GLB is also asserted to be a reason for the accelerated demutualization of insurance companies. As indicated earlier in this chapter, demutualization permits insurance companies to acquire not only insurance companies but other types of financial institutions. And by demutualizing, insurance companies can acquire capital for acquisitions. The act certainly accelerated bankassurance, the sale of insurance products by banks, although at a slower pace than originally thought.

Even before the passage of the GLB bill, commercial banks were becoming involved in some aspects of commercial banking. For several years, in addition to selling mutual funds (discussed in Chapter 7), banks have become successful at selling annuities, both variable and fixed, mainly manufactured by other investment managers. In addition, insurance companies have been entering one part of banking, namely trust banking. Many life insurance agents put some of their clients' assets and life insurance policies in trusts. As a result, several life insurance companies have obtained trust licenses.

Few insurers have planned to go into retail commercial banking. However, Metropolitan Life, after having become a public stock insurance company in March 2000, announced in August 2000 that it would acquire Grand Bank, N.A., in New Jersey and go into retail commercial banking, something that could not have been accomplished before the GLB bill was passed.

Internationalization of the Insurance Industry

Globalization has occurred in many industries, including the insurance industry. With respect to the United States, globalization operates in two directions. With respect to the first direction, U.S. insurance companies have both acquired and entered into agreements with international insurance companies and begun operations in other countries. With respect to the second, international insurance companies, mainly European, have become even more active in acquiring U.S. insurance and investment companies.

Among the reasons for the increased entry by international insurance companies into the U.S. insurance industry and other U.S. financial sectors are (1) the more rapid growth of

the U.S. financial businesses relative to the international financial business, (2) the attractive demographics and income of potential U.S. clients, and (3) the less regulated environment of the U.S. insurance industry. Among the major international acquirers of U.S. insurance companies have been AXA Group (French), ING Group (Dutch), Allianze (German), Fortis (Dutch-Belgian), and Aegon (Dutch).

Demutualization

Since mid 1995, several insurance companies have changed from mutual companies to stock companies for reasons discussed previously in this chapter. Since insurance companies are regulated by states, such changes have to be preapproved by the state insurance regulatory department. Many industry observers believe that the recent demutualized insurance companies will either acquire other financial companies or will be acquired by other financial companies, or both.

Some states, as indicated above, have approved the mutual holding company status, and so the resident insurance companies had a choice of converting to a mutual holding company or a pure public stock company. Other states, including New York, have not approved the mutual holding company status, and so the only option remaining to a mutual company is to demutualize, that is, become a public stock company.

Key Points That You Should Understand Before Proceeding

1. The Glass-Steagall Act of 1933 prevented any one company from being simultaneously involved in commercial banking, investment banking, and insurance.
2. In response to a changing financial landscape, the Gramm-Leach-Bliley Act of 1999 removed the above restriction and is expected to accelerate mergers among formerly distinct financial institutions.

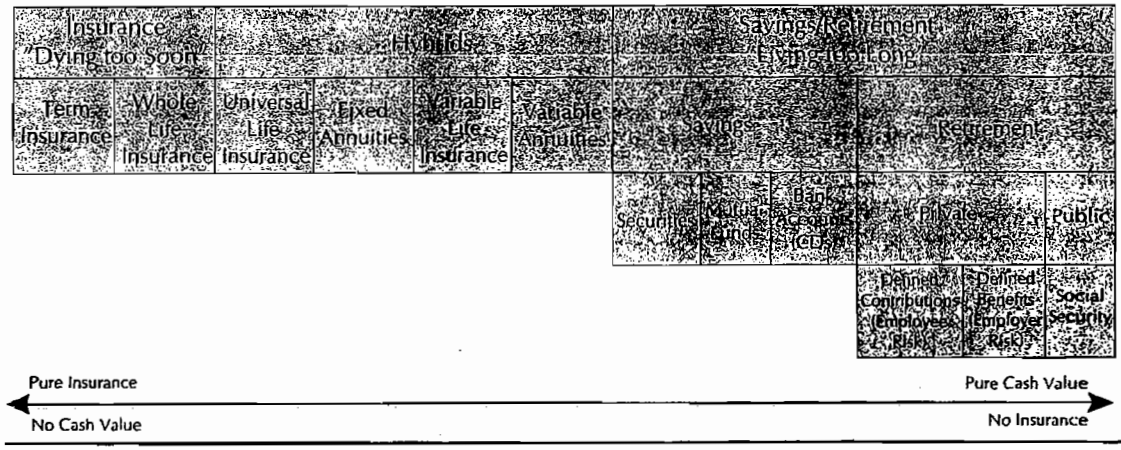
EVOLUTION OF INSURANCE, INVESTMENT, AND RETIREMENT PRODUCTS

Even prior to the Financial Modernization Act of 1999, there was an increasing overlap of insurance, investment, and pension products and the distribution of those products. The passage of this act has accelerated this convergence. This chapter as well as the next two discuss insurance companies, investment companies, and pension plans with their increasingly overlapping products.

Three decades ago, there were three distinct types of products for individuals: insurance, savings/investment, and retirement. The specific products in each distinguishable category were as follows. Insurance products included term life and whole life. Savings/ investment products included stocks, bonds, and mutual funds. Retirement products included Social Security (provided by the government), defined benefit and defined contribution plans (provided by employers), and individual retirement accounts (IRAs) (provided by investment companies).

During the past two decades, many products have been developed that fit into two or even three of these categories. Into which of these three categories, for example, does an IRA sold to a customer by a life insurance agent fit? Arguably, the correct answer to this question is all three categories. Figure 6-2 provides a summary of some of the products on the insurance/savings/retirement spectrum, which are really *hybrids*. We have discussed the various insurance products in this chapter. Mutual funds and other investment products

Figure 6-2 Insurance/Savings/Retirement Vehicles



Source: *Frank J. Jones, "An Overview of Institutional Fixed Income Strategies," in Volume 1 of Professional Perspectives on Fixed Income Portfolio Management (Hoboken, NJ: John Wiley & Sons, 2000).*

are discussed in Chapter 7. Retirement products are discussed in Chapter 8. This section discusses products that are hybrid retirement and savings products but which are often manufactured and distributed by insurance companies.

Products that are a hybrid of retirement and investment products and are often distributed by insurance companies and agents are 401(k)s, Roth 401(k)s, and variable annuities. These products are also often distributed by many insurance companies, and the insurance companies often include some of their own products within these categories. Because these plans are retirement plans, there are tax advantages to the investor.

Under the 1954 Internal Revenue Service (IRS) rules, *qualified plans* are tax-deferred plans set up by employers for employees. The employees pay taxes only when they withdraw the funds; that is, the contributions are not taxed, they are "before taxes." When employers make contributions to employee plans, the employers also, if they meet several requirements, receive a tax benefit (typically a tax deduction for the payment). Because these plans receive tax benefits and are intended for retirement, typically withdrawals prior to age 59½ are subject to a 10% (of principal) penalty tax, although there are some exceptions. In addition, withdrawals must begin by age 70½ to limit the duration of the tax advantage. 401(k) and Roth 401(k) plans are such qualified plans. The entire amount of all withdrawals is subject to taxation at the owner's income tax rate.

401(k) Plans and Roth 401(k) Plans

401(k) plans, which were authorized by the Revenue Act of 1978, are plans provided by an employer whereby an employee may elect to contribute pretax dollars to a qualified tax-deferred retirement plan. The employer offers a range of investment options from which the employee selects a vehicle to invest these funds. The company's own stock, if the company is public, is often one investment option. Most current employer 401(k) plans provide a diversified portfolio of mutual funds to their employees, typically including funds offered by

one or more investment companies. 401(k) plans are offered to employers by several distribution systems, primarily investment companies and insurance companies. The employer often matches a certain portion of the employee's contribution. Because of the tax deferral privilege, there are limits on the amount the employee can contribute and also that the employer can match.

IRAs (Individual Retirement Accounts) and ROTH IRAs

While a 401(k) is an *employer-sponsored* retirement program, the most common types of IRAs are *personal* tax-deferred retirement plans; that is, they are set up at the initiative of the employee/investor. IRAs were created by the Employee Retirement Income Security Act (ERISA) of 1974. There are limits on the amount that may be invested in an IRA and the amount of earned income to qualify for an IRA investment.

Some IRAs, however, are employer sponsored. The various types of IRAs, both individually sponsored and employer sponsored, are as follows. Individually sponsored IRAs include traditional IRAs, non-deductible IRAs, Roth IRAs, and rollover IRAs. Employer-sponsored IRAs include Simplified Employee Pension IRAs (SEP IRA) plans and the Savings Incentive Matching Plan for Employees IRAs (SIMPLE IRA).

Traditional and Roth IRAs are vehicles for individuals to set up their own retirement plans outside their employment. Both types permit assets to accumulate free of taxes. In general, the Roth IRA, provided by the Taxpayer Relief Act of 1997, is similar to the traditional IRA, although the taxability of its contributions and withdrawals is reversed. Whereas contributions to traditional IRAs are tax deductible, contributions to Roth IRAs are made after tax (that is, are not tax deductible). On the other hand, with respect to distributions, traditional IRA distributions are taxed as ordinary income (that is, even capital gains and dividends are taxed as ordinary income), and distributions from Roth IRAs are tax free. Overall, traditional IRAs are taxed on the way out (at time of distribution), while Roth IRAs are taxed on the way in (at the time of investment).

In general, absent certain special circumstances (such as death, disability, or certain unemployment expenses), withdrawals from either IRA type prior to age 59½ are subject to a 10% IRS early withdrawal penalty. Some of the other rules on voluntary and mandatory distributions are very complex. Contributions to both Roth and traditional IRAs are limited to $5,000 per year ($6,000 if age 50 or older) during 2008, and even the ability to contribute this amount is phased out at higher incomes for both types of IRAs.

Rollover IRAs, also called "conduit IRAs," are used for rolling over eligible distributions from employer-sponsored retirement plans, such as 401(k)s. Rollover IRAs may be used when an individual is leaving an employer and wants to continue this retirement plan, that is, does not want to be subject to penalties or distribution/withdrawal taxes. The employees can roll over assets from an employer-sponsored program into a rollover IRA and subsequently roll them back to another employer-sponsored plan. Rollover IRAs are very similar to traditional IRAs.

Investors not eligible for traditional or Roth IRAs can invest in non-deductible IRAs. In these IRAs, contributions are after tax and gains are taxed at withdrawal, but the inside buildup is tax free.

SEPs and SIMPLEs are both qualified employer-sponsored IRAs wherein the contributions by the business are tax deductible to the business. The SEP is a type of IRA that allows an employer to make a tax-deductible contribution of from 0% to 25% of earned income per year, per participant, up to $46,000. SEPs are ideal for the self-employed or small business

owner. According to the SIMPLE IRA, which became available during 1997, the employer must match employee contributions as low as 1% up to 3% of compensation; or must make a nonelective contribution of 2% of compensation to all eligible employees.

As can be seen with respect to both product design and distribution channels, the distinction among insurance, investment, and retirement products has become very blurred.

SUMMARY

In general, insurance companies bear risk from parties who wish to avert risk by transferring it to the insurance companies. The party seeking to transfer the risk pays an insurance premium to the insurance company.

Insurance companies pay the insured when and/or if the insured event occurs. Because insurance companies collect premiums initially and pay the claims later, the initial revenues are invested in a portfolio, and portfolio returns become another important revenue for the insurance company. Consequently, insurance companies are financial intermediaries that function as risk bearers.

The events insured can be death (insured by life insurance companies), health problems (health insurance companies), or housing or automobile damage (P&C insurance companies). In addition, there are different types of insurance for the different types of risks. Insurance companies have also become active in providing retirement and investment products. These different types of insurance liabilities reflect different types of risks and, therefore, the investment portfolios of these types of insurance companies differ significantly.

Insurance companies can be owned by stockholders (stock or public companies) or by their policyholders (mutual companies). Insurance companies are regulated by states, not the federal government. The regulations can vary significantly from one state to another.

The passage of the Gramm-Leach-Bliley Act (called the Financial Modernization Act of 1999) has eliminated the barriers between insurance companies, commercial banks, and investment banks, and various combinations of these types of companies will continue to evolve.

KEY TERMS

- 401(k) plans, 117
- Annuity, 100
- Bankassurance, 105
- Cash value life insurance, 109
- Crediting rate, 99
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QUESTIONS

1. a. What are the major sources of revenue for an insurance company?
   b. How are its profits determined?
2. Name the major types of insurance and investment-oriented products sold by insurance companies.
3. a. What is a GIC?
   b. Does a GIC carry a "guarantee" like a government obligation?
4. What are some key differences between a mutual fund and an annuity?
5. Why should a purchaser of life insurance be concerned about the credit rating of his or her insurance company?
6. a. Does the SEC regulate all insurance companies?
   b. If not, who regulates them?
7. Does the insurance industry have a self-regulatory group and, if so, what is its role?
8. What is the statutory surplus and why is it an important measure for an insurance company?
9. What is bankassurance?
10. a. What is meant by "demutualization"?
    b. What are the perceived advantages of demutualization?
11. Comment on the following quotation from Frank J. Jones, "An Overview of Institutional Fixed Income Strategies," in Volume 1 of *Professional Perspectives on Fixed Income Portfolio Management* (Hoboken, NJ: John Wiley & Sons, 2000):

    > An important impediment to the use of the total rate of return objective by stock life insurance companies is the role of equity analysts on Wall Street. . . . These equity analysts emphasize the stability of earnings and thereby prefer stable income to capital gains. Therefore, they consider only income and not capital gains, either realized or unrealized, in operating income—an important measure in their overall rating. While this practice of not considering capital gains may be appropriate for bonds, it certainly is inappropriate for common stock and provides a significant disincentive to life insurance companies for owning common stock in their portfolios. . . . this equity analyst practice does a disservice to policyholders of stock life insurance companies since their insurance companies end up having inferior asset allocations.

12. What are term insurance, whole life insurance, variable life insurance, universal life insurance, and survivorship insurance?
13. Why are all participating policies written in an insurance company's general account?
14. Whose liabilities are harder to predict, life insurers or property and casualty insurers? Explain why.
15. How does the Financial Modernization Act of 1999 affect the insurance industry?