A. The Industry and Its Products

The size of the insurance industry is impressive even in the context of an economy as large as that of the United States. It employs 2.5 million people, has total revenues of approximately $1.9 trillion and accounts for 2.5% of the nation’s GDP.1 The economic power implicit in these numbers, taken alone, would provide sufficient reason for regulating the insurance industry. An even more important justification for regulation stems from the role that insurance products play in our society. Individuals and businesses rely on insurance to offset a wide range of adverse events. If insurance is unaffordable or unavailable or if insurance companies fail to communicate policy terms clearly or are unwilling or unable to honor their obligations, the impact can be devastating. The primary objective of insurance regulation is to prevent such things from happening.

The McCarran-Ferguson Act passed by Congress in 1945, provides that the day-to-day regulation of the business of insurance will be left largely to the states. However, in 1999, Congress reclaimed some of the authority delegated to the states when it passed the Gramm-Leach-Bliley Act (GLB). GLB permits the combination of insurance companies, securities firms and banks within the same holding company structure, overriding state law to the contrary. It also allows banks to act as agents for the sale of insurance products, allocates regulatory jurisdiction over the insurance industry among state and federal agencies and mandates certain consumer protection rules.2 Further federal intervention came in 2010, when Congress passed The Patient Protection and Affordable Care Act (PPACA) which established a comprehensive regulatory scheme for the health insurance industry.3

The American insurance industry offers three groups of products: property/casualty insurance; life insurance and annuities; and health insurance. Property casualty policies sold by “p/c” insurers protect individuals and businesses from

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1 See Insurance Information Institute, Fact Book 2016 V, 32, 36, 43 (2016). The total revenue figure includes the Life/Health, Private Health and Property/Casualty segments of the insurance industry. The other figures include only Life/Health and the Property/Casualty.

2 The insurance provisions of GLB (Pub. L. 106-102) are scattered throughout Titles I and III.

3 See Public Law 111-148; 124 Stat. 119. The Act runs over 1000 pages. A week later a series of minor amendments were made as part of a bill that included unrelated matters. See Public Law 11-152; 124 Stat. 1029.
damage to their real and personal properties and from liability claims. Life insurance and annuities are both sold by life insurance companies. Health insurance is also sold by life insurance companies, but most of the market belongs to a variety of other entities including non-profits such as many of the Blue Cross and Blue Shield companies. The largest single health insurance product of all is the federal Medicare program. Chapter One provides an overview of these three segments of the insurance industry.

1. Property/Casualty Insurance

The property/casualty (p/c) industry took in approximately $497 billion in premiums during 2014.\(^4\) Net income was $56 billion extending a recent pattern of solidly profitable results.\(^5\) The industry sells a wide array of products. The protections provided by these products frequently overlap and the names under which they are marketed often provide little guidance as to what they insure. The larger and more established products and groups of products are referred to as “lines.” Table I identifies the more important p/c lines and indicates whether they are “personal lines,” which is the designation given to policies sold to individuals, or

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4 See Insurance Information Institute, supra note 1, at 43.
5 See id.
6 For a general description of the most frequently encountered property/casualty lines see id. Ch. 6.
are “commercial lines,” the designation given to insurance sold to businesses. It also indicates whether a particular line covers property damage, liability claims or both. The property protected against damage by p/c insurance may be real or personal. Property/casualty policies may also protect the insured against the non-performance of a contractual obligation owed to the insured by a third party.

Private automobile insurance generates more premium income than any other property/casualty industry product.7 Homeowners insurance ranks second in size among p/c products.8 Together these two personal lines account for more than half of all p/c premiums. Both auto insurance and homeowners insurance typically combine coverage for property damage and liability claims.

The multiplicity of commercial lines products that are available gives businesses the ability to configure protection for their assets and protection from liability claims in a variety of ways. They can purchase commercial multi-peril policies that provide a broad spectrum of damage and liability coverage or they can buy unbundled protection from very specific types of hazards such as fire, product liability, employee dishonesty or earthquakes.

General liability policies protect against the same kinds of liability risks covered by multi-peril policies, i.e., liability to third parties arising from products, premises, and operations, but do not provide asset protection. General liability insurance can itself be broken down into coverage for product liability and for other types of liability risks such as errors and omissions, environmental pollution, liquor liability, etc.

Workers compensation insurance is the largest of the commercial lines.9 State laws require most employers to provide this protection for their employees. The policies cover the cost of medical care and rehabilitation for injured workers, compensation for lost wages and death benefits for dependents. The cost of workers compensation insurance is a major expense for most businesses.

Professional liability insurance protects against negligent acts, errors or omissions in the course of professional activities, such as medicine or law.

Allied lines cover property damage caused by wind, water and vandalism. This coverage is often packaged (allied) with fire insurance.

Ocean marine insurance provides property and liability coverage for vessels and their cargos.

Inland marine insurance provides protection for goods transported by land, for transportation related structures such as bridges and pipelines, for communications equipment and for valuable, movable property such as jewelry and art.

Business interruption insurance provides payments to substitute for the loss of income resulting from the destruction of properties (buildings, plant, equipment, etc.) that are used to produce income.

Fidelity bonds protect businesses from employee dishonesty.

Surety bonds provide reimbursement to the beneficiary of a policy in the event that the policyholder fails to complete a project on time or in accordance with contractual specifications. For example, the owner of a major league baseball

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7 See Insurance Information Institute, supra note 1, at 59. Private auto insurance generated approximately $183 billion in premiums in 2014.
8 See id.
9 See id.
franchise constructing a new stadium might require the general contractor to post a surety bond that will provide protection in the event the general contractor doesn’t perform its obligation to complete the stadium according to specifications and in time for opening day.

Mortgage insurance provides for payment to a mortgagee in the event the mortgagor defaults. Financial guaranty insurance provides the same type of protection to the holders of other types of debt instruments, most notably municipal bonds. The value of mortgage and financial guaranty insurance is that in the event of a default, the debt holder can look to a financially strong insurance company for payment.

Title insurance protects both property owners and mortgagees of real property against defects in the owners’ rights with respect to the property, but only to the extent that an accompanying title report or title abstract fails to disclose such defects.

Table I above identifies the most commonly encountered p/c product lines. Most of these lines are widely available and usually marketed with standardized provisions. Insurers also write specific policies to cover large, unique risks, such as rock concerts and athlete’s limbs. Indeed, it is hard to imagine a type of risk related to a legitimate individual or business activity for which p/c insurance cannot be purchased—at a price.

The fact that state laws require every driver to carry auto insurance and most businesses to carry workers compensation insurance means that the demand for these lines expands with population and economic growth. Likewise, the fact that lenders require homeowners insurance and title insurance as a condition for granting home loans fuels the market for these products.

Alternative markets is the collective name given to devices that serve as substitutes for the purchase of commercial lines insurance from traditional insurance companies by individual businesses.10 These devices include self-insurance, the establishment of loss sharing arrangements among businesses that are exposed to the same types of risks, the formation of purchasing groups to obtain insurance at favorable rates, and the creation of captive insurance companies. The alternative markets enable businesses to obtain protection at a lower cost and to escape the volatility that exists in the cost and availability of traditional commercial lines. The emergence of the alternative markets has had a negative impact on the growth and profitability of commercial lines. It is estimated that the alternative markets now account for about 30% of the commercial lines market.11 The growth of the alternative markets was stimulated by the passage of the federal Risk Retention Act, which provides that liability risk retention and insurance purchasing groups are not subject to certain onerous state insurance laws.12

Combined ratio is a formula used by the property/casualty industry to assess the financial success of its core function—underwriting risk. The combined ratio is calculated by determining the percentage of each premium dollar received by an insurer that is paid out in losses, loss adjustment expenses and other

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10 See Insurance Information Institute, Captive and Other Risk Financing Options, October 2013, at http://i.i.i.org/issue_updates/captives-and-other-risk-financingoptions.html.
underwriting expenses. If the combined ratio is more than 100 the insurer has incurred an underwriting loss. At the heart of the process of setting the premium rates that make up one side of the combined ratio formula is the work of insurance company actuaries who use complex mathematical formulas to project claims and claims related expenses.

As a result of competitive pressures, regulatory policies, and the losses occasioned by catastrophic occurrences (often referred to as “cats” in industry jargon), annual underwriting losses have been the norm for the p/c industry. Indeed, the industry did not record an underwriting profit, i.e., a combined ratio of less than 100, between 1979 and 2004. What prevents mass insolvencies is that in a “normal” year the earnings produced by the industry’s investment portfolio more than offsets the underwriting loss, allowing it to show a profit. The size and revenue producing capacity of that portfolio is enhanced by the fact that premiums are generally received at the beginning of a policy term, but that claims are paid out over time—in some cases over a period of years. However, within this normal pattern of financial results the differences in the magnitude and number of catastrophic occurrences from year to year can produce huge variations in earnings. The p/c industry’s pattern of achieving profitability in the face of underwriting losses was interrupted in 2001. Claims arising from the World Trade Center attack pushed the industry’s underwriting loss to $53.5 billion resulting in an after-tax loss of $7 billion. However, this result gave the industry the motivation and the rationale for obtaining significant rate hikes. These increases and the judicious use of reinsurance helped the industry to achieve a respectable combined ratio of 101 and a manageable underwriting loss of $6 billion in 2005, despite catastrophe losses of $58 billion inflicted by Katrina, Rita, Wilma, and a number of smaller hurricanes. In 2006 and 2007, the p/c industry achieved unprecedented underwriting results. A dramatic drop in catastrophic losses combined with strong premium income produced underwriting profits of $31.1 billion and $19 billion. In 2008, the large hit to the industry’s investment portfolio precipitated by the worldwide financial crisis coupled with significant catastrophic losses resulted in earnings shrinking to $3 billion.

The regulatory response to the fact that catastrophic occurrences are both inevitable and unpredictable is to require the maintenance of large loss reserves made up of liquid assets. The large loss reserves that the p/c industry is required to maintain result in very high equity to asset ratios and a correspondingly low return on equity. Return on equity is one of the most important determinants of a business’ ability to attract capital.

In analyzing the earnings performance of the p/c industry, it is important to keep in mind that the rates charged for important p/c products such as auto, homeowners, and workers’ compensation insurance are subject to regulatory

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13 During a 21 period ending in 2002, the cumulative underwriting loss amounted to more than $370 billion. See Insurance Information Institute, Fact Book 2004 17 (2004).
17 See Insurance Information Institute, supra note 1, at 37, 128.
review and, in many cases, prior approval. Downward adjustments from rates requested by the industry are very common. In addition the relatively slow recovery of the U.S. economy from the recession of 2008, has been reflected by the fact that it was not until 2012 that the industry’s premium income exceeded the level achieved in 2007.\(^\text{19}\) Exhibit 1 at the end of the Chapter illustrates how the alignment of the various factors discussed above have impacted the industry’s financial results in particular years.

2. Life Insurance and Annuities

The life insurance industry, despite its name, has three major product lines—life insurance, annuities and health insurance. The industry originally offered only life insurance, and it still carries that name. However, annuities are now the industry’s largest revenue producer, providing, in most years, more income than life insurance and health insurance combined.\(^\text{20}\) Health insurance products are discussed separately in Subsection 3 below.

Total income of the life insurance industry for 2014 amounted to one trillion dollars.\(^\text{21}\) Premiums accounted for $658 billion, investment income for $267 billion and other income for $74 billion.\(^\text{22}\) During 2014 the life insurance industry had a net gain from operations of $51 billion.\(^\text{23}\)

Historically, a significant portion of the nation’s life insurance companies were organized as mutuals. Although there has been a strong shift toward stock corporations in recent years, the mutuals are still a force in the industry.\(^\text{24}\)

Whole life individual policies are the most familiar form of life insurance protection. They provide permanent protection during the policyholder’s life as long as the premiums, which remain constant during the life of the policy, are paid. Premiums are determined primarily by the insured’s age at the time the policy is purchased, although physical condition and other risk factors such as whether or not the insured smokes are taken into account. The premiums charged during the early years a policy is in force are higher than the actual cost of providing the coverage because the insured’s actuarial chances of dying early into a whole life policy are slight. However, as the insured ages and the chances of dying increase, the monthly premiums do not cover the actuarial cost of protection. However, the premiums collected during the early years together with investment income earned thereon provide the insurer with sufficient funds to pay the death benefit and to operate on a profitable basis.

In recent years, two variations on the traditional individual whole life policy have become popular. Variable life insurance policies require a fixed monthly payment, but allow the policyholder to direct the investment of the premiums into a specific portfolio of investments that resemble a mutual fund. The amount of the

\(^{19}\) See Insurance Information Institute, supra note 1, at 43; Insurance Information Fact Book 2013 37 (2013).

\(^{20}\) See American Council of Life Insurers, Life Insurance Fact Book 2015 35-37 (2015). For the year 2014 annuity revenues were $362 billion, life insurance premiums $138 billion, and health insurance premiums $158 billion. id.

\(^{21}\) See American Council of Life Insurers, supra note 20, at 37.

\(^{22}\) See id.

\(^{23}\) See id. at 41.

\(^{24}\) See id. at 1-2.
death benefit and the cash surrender value depend on the performance of the investments chosen by the policyholder. However, there is usually a guaranteed minimum death benefit. Universal life insurance allows the policyholder to vary the amount and timing of premiums within certain limits thereby adjusting the death benefit. This enables the policyholder to fine tune the amount of coverage in response to changing family circumstances, such as the birth of a child, or to changing financial conditions, such as a spike in the rate of inflation.

Term life insurance is the alternative to whole life insurance. Term life policies guaranty coverage for a specific period of time, usually five to ten years, in return for a fixed monthly premium. The cost is significantly lower than for an equivalent amount of whole life protection. For example, a non-smoking thirty-five-year-old male may be able to purchase a ten-year term life insurance policy providing a $100,000 death benefit for about $12 a month. However, there is no build-up of a cash surrender value, no guaranty that the policy will be renewed at expiration if the health of the insured has deteriorated and no payment if death occurs after the policy expires. Term policies are an inexpensive way of obtaining life insurance coverage for a limited period of time—if the insured is not elderly or in poor health.

Group term life insurance paid for by employers is part of many employee benefit program. Coverage under these policies generally terminates when an individual ceases to be an employee. The ex-employee may have an option to convert the policy to individual whole life coverage by assuming the obligation to pay premiums. Since 2007, the amount of coverage provided to employees through group policies has dwindled as evidenced by a decline in the number and aggregate face amount of new certificates issued to individuals pursuant to group policies and a decrease in the aggregated life insurance in force pursuant to group policies.25

A large percentage of life policies generate a steady inflow of premium income for periods of 20, 30, or 40 years, until death occurs and the money is paid out. Given the predictable build up in value resulting from the long term investment of these funds and the reliability of the mortality tables, it is not particularly alarming that at the end of 2014 there was $20.1 trillion of life insurance in force, while the total assets of all American life insurance companies amounted to only $6.4 trillion.26

Annuities are marketed and function more like an investment product than an insurance policy. There are two major types of annuities—fixed and variable. Fixed annuities, as their name implies, provide fixed, periodic payments beginning on a specific date (often at retirement) that continue for the remaining life of the beneficiary or beneficiaries. Variable annuities typically represent investments in an underlying portfolio of securities. The payments made to the beneficiaries are dependent upon the performance of the portfolio. The attractiveness of annuities to the consumer rests in large part on their preferred tax status. As a general rule, the build up in the value of assets that are held by a life insurance company under an annuity contract is not taxable to the annuitant prior to payout. This contrasts with the tax treatment applicable to competing financial products such as mutual funds and certificates of deposit. Employer retirement plans often utilize qualified group annuities.

One characteristic of variable annuities and variable life policies that sets them apart from almost all other insurance products is that they may come

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25 See id. at 65, 72.
26 See id. at 7, 63.
within the definition of “securities” for purposes of the federal securities laws.\textsuperscript{27} This means that insurance companies that issue these products must comply with the registration requirements of the Securities Act of 1933 and that their sale of these products are subject to the prohibition against deceptive and manipulative practices contained in Section 10(b) of the Securities Exchange Act of 1934. In addition, individuals that sell them must be registered as brokers pursuant to the ‘34 Act. Property/casualty insurance products and most of the life insurance industry’s other products are regulated almost exclusively by the states.

The financial results of the life insurance industry are driven by sales volume and by the performance of its investment portfolio which typically accounts for about 20\% of annual income. Earnings tend to be less volatile than that of the p/c industry. This is particularly true with respect to traditional life insurance products. Claims for death benefits never deviate very far from the predictions of the standard mortality table which is the basis for setting life insurance premiums. The low interest rate environment that has existed over the last few years and the shrinkage in individual disposable income have had a depressing effect on the sales of annuities, particularly fixed annuities.

3. Health Insurance

Private health insurance is a relatively new insurance product, dating back no further than the 1930s. Policies provide beneficiaries either with reimbursement for medical expenses or with pre-paid access to medical services provided by HMOs. Most individuals receive their coverage through group health insurance policies purchased by their employers.\textsuperscript{28} Rates for health insurance are subject to regulatory scrutiny in most states and, increasingly, to rate approval. Private market health insurance premiums written in 2014 amounted to $707 billion.\textsuperscript{29}

Health insurance is offered by commercial entities that are part of the life insurance industry, but most of the private coverage is written by a variety of other entities, including Blue Cross and Blue Shield, some of which are not-for-profits.\textsuperscript{30} In 2014, the for-profit life insurance industry had health insurance earnings of $6.9 billion on premium income of $158 billion.\textsuperscript{31} Medicare dominates the health insurance market for the over sixty-five population.

The federal health care reform legislation enacted in 2010, known as PPACA, marks a revolution in the nature of the health insurance sold in the United States. The private health insurance industry is left intact, but it will operate under a comprehensive set of rules that are federal in origin, but largely administered by the existing state regulatory apparatus. The states retain the ability to enact regulations that do not conflict with PPACA. In June of 2012 the Supreme Court upheld the Constitutionality of PPACA, except for the so-called Medicaid expansion penalty.\textsuperscript{32} Many of the underwriting criteria and policy provisions which health insurers have

\textsuperscript{27} See SEC v. VALIC, 359 U.S. 65 (1959).
\textsuperscript{28} See Insurance Information Institute, supra note 1, at 36.
\textsuperscript{29} See Insurance Information Institute, supra note 1, at 36.
\textsuperscript{30} See id. At 36-37.
\textsuperscript{31} See American Council of Life Insurers, supra note 20, at 37, 41.
traditionally utilized to determine whether to offer or deny coverage or as a basis for setting rates and restricting coverage can no longer be used. These include pre-existing medical conditions, annual and lifetime limitations on benefits and rate distinctions between individual and small group markets. Rate increases will be subject to greater scrutiny and many coverage provisions will be standardized. As the various provisions of PPACA come into force, it will be interesting to observe which of the current major players in the market are able to adapt and prosper under the new regime, and whether there will be new entrants who may believe that they can successfully compete in this highly regulated environment.

Long term care insurance is a relatively new product provided by the life insurance industry. It pays for the expenses that arise when the policyholder can no longer perform certain activities of daily living—bathing, eating, dressing, getting out of bed, etc. These expenses are not covered by Medicare. One of the provisions of PPACA designated as the “Class Act” established a federal long term care program that competed directly with these private plans. However, the Obama administration decided not to implement the federal program because of concerns about its financial viability and the enabling provisions were repealed in 2013 as part of the Fiscal Cliff Act.

Federal and state regulation of health insurance is discussed in Chapter Twelve.

4. Reinsurance—Insurance for Insurers

Insurance companies make money by prudently assuming and spreading risk. An auto insurer takes on the risk of property damage and liability claims with respect to the autos it insures. A life insurance company takes on the risk of premature death with respect to the individuals whose lives it insures. These insurers spread these financial risks among the policyholders within their respective lines of insurance by charging an appropriate premium. If all goes according to sales projections and actuarial calculations, the aggregate premiums paid by each group of policyholders will cover policy claims and operating expenses and enable the insurer to turn a profit.

But, suppose an insurance company concludes that some segment of its policy portfolio is not consistent with its criteria for sound underwriting. For example, a p/c company may find itself with a large concentration of homeowner’s policies in an area that could be devastated by a single hurricane or earthquake. The insurer can utilize a reinsurance transaction to rectify the situation. The reinsurer assumes the risk related to a portion of the insurer’s portfolio and in return is “ceded” a portion of the related premiums. The risk assumed by the reinsurer may consist of specific policies or it may consist of a percentage or layer of the risk in a particular group of policies. A life insurance company may also use reinsurance to adjust its risk exposure. It may write a very large policy on the life of an individual but then transfer part of that exposure to a reinsurer. The exposures to investment risk presented by annuities and the risk of escalating costs of providing medical care
pursuant to health insurance policies can also be laid off to reinsurers. A company may reinsure for reasons other than risk management. Such transactions can strengthen a company’s capital position by reducing its reserve requirements or enable it to exit a line of business it no longer wishes to pursue. What does a reinsurer do when it wants to modify its risk exposure? It enters into a reinsurance transaction with other reinsurers. This is known as retrocession and the reinsurers who assume the risk are known as retrocessionaires.

Reinsurance is a large business. In 2014, the life/health and property casualty industries ceded $158 billion of premiums. Reinsurance is a specialized business, with a few very large companies controlling the bulk of the market. It is also an international business dominated by non-U.S. companies. This fact proved serendipitous in 2005, when hurricane Katrina and a series of other hurricanes combined to inflict an estimated $58 billion in insured losses. The fact that a significant percentage of these losses were reinsured with foreign companies saved the U.S. p/c industry from incurring an operating loss for the year as it did in 2001, as the result of the World Trade Center attacks.

5. The Sale of Insurance Products

Insurance companies design and perform the terms of insurance policies and some insurance companies also sell their policies directly to the consumer. However, one of the peculiarities of the industry is that most sales of insurance products are made through intermediaries. These intermediaries are given a variety of names—agent, career agent, exclusive agent, general agent, independent agent, broker, and producer. Their legal relationship to the insurer may be that of independent contractor, agent or employee. Independent agents, general agents and brokers sell the insurance products of more than one insurer. Most sales of insurance products result in the payment of a commission to an intermediary by an insurance company. Sales commissions are one of the insurance industry’s largest items of expense. In 2014, they amounted to more than $100 billion. This makes insurance sales a very large industry in its own right. The interests of insurance companies and their distribution function don’t always align. Insurance agents have their own trade associations and express their own views on insurance legislation. Employees that perform sales functions at some insurance companies have unionized in order to bargain collectively with their employers.

The fact that most insurance is sold through a system that is expensive and semi-autonomous creates a variety of issues for the industry. Commission expenses impact profitability. The fact that other segments of the financial services industry, i.e., banks and securities firms utilize less costly and more closely managed distribution mechanisms undercuts the competitiveness of the

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36 See Insurance Information Institute, supra note 1, at 59; American Council of Life Insurers, supra note 20, at 57, 60.
37 See Insurance Information Institute, supra note 1, at 4.
38 See id. at 3-4.
40 See American Council of Life Insurers, supra note 20, at 48, 49; Insurance Information Institute, supra note 1, at 44.
insurance industry. Failure to exercise appropriate control over sales personnel who may be motivated to maximize sales commissions to the detriment of their customers has subjected the industry to expensive lawsuits.

Early attempts by the banking industry to serve as an alternative sales channel for insurance products gave rise to state legislation prohibiting such activity which the banking industry challenged on the grounds of federal preemption.\textsuperscript{41} One of the objectives of GLB was to clarify both the authority of banks to sell insurance products and the extent to which the states can regulate such activity.

### 6. Government Insurance Programs

The federal government plays an important role in satisfying the nation’s insurance needs. It operates a diverse portfolio of insurance programs that implement social policies and/or fill gaps in the private market. Some of the programs are narrowly focused and modest in size. At the other end of the scale is the Social Security System that dwarfs anything that exists in the private sector. Federal authority enables programs like Social Security to achieve universal, standardized coverage. A number of the federal insurance programs are administered by the insurance industry with the federal government providing financial support.

**Retirement Systems and Life and Health Insurance.** The federal Old Age, Survivors’ and Dependents’ Insurance program, better known as Social Security, is a compulsory program that depends largely upon taxes collected from the working population and their employers to fund benefits paid to retired and disabled individuals. Medicare provides health insurance for the aged covering hospital care, doctors’ fees, outpatient care and durable medical equipment. Since January 1, 2006, Medicare has covered the cost of some prescription drugs. Medicaid provides health insurance for those who cannot afford it. The federal government operates a retirement and unemployment system for railroad workers.\textsuperscript{42} Since World War I there has been a life insurance program covering military personnel on active duty and veterans. During World War II, the aggregate insurance outstanding under this program almost equaled the total amount of private life insurance in force.\textsuperscript{43} Civilian employees of the United States government are entitled to participate in federally operated health insurance and retirement programs.\textsuperscript{44}

**Deposit and Brokerage Account Protection.** Federal Deposit Insurance Corporation (FDIC) insurance provides up to $250,000 of coverage for deposits at banks, thrifts, and credit unions.\textsuperscript{45} The Securities Investors Act of 1970 established the Securities Investor Protection Corporation (SIPC) which provides up to $500,000 of protection for cash and securities in the accounts of customers of broker/dealers and member firms of the national securities exchanges.\textsuperscript{46}

**Loan Guaranties.** The Federal Housing Administration\textsuperscript{47} and U.S. Department of Veterans Affairs\textsuperscript{48} provide guaranties for a variety of home mortgage loans.

\textsuperscript{41} See infra Chapter 11, Subsections B & C.
\textsuperscript{42} See 45 U.S.C. chs. 9, 11.
\textsuperscript{44} See 5 U.S.C. chs. 83-89.
\textsuperscript{47} See 12 U.S.C. 1709.
\textsuperscript{48} See 38 U.S.C. 3702-3703.
made by private lenders. The federal government also provides guaranties for student loans\textsuperscript{49} and for loans made to small businesses.\textsuperscript{50} In order to stimulate U.S. foreign trade, the federal government provides guaranties against political risk to American companies that invest and trade overseas.\textsuperscript{51}

\textit{Miscellaneous Programs that Fill Gaps in the Private Markets.} The Longshoremen’s and Harbor Worker’s Compensation Act provides workers’ compensation coverage for those engaged in maritime trades.\textsuperscript{52} The Federal Emergency Management Agency oversees a national flood insurance program.\textsuperscript{53} The Federal Crop Insurance Corporation, a part of the Department of Agriculture, administers a federal crop insurance system.\textsuperscript{54} The Maritime Administration provides insurance against war risks for ships, their cargoes and crews.\textsuperscript{55} The newest federal insurance program came into existence on November 26, 2002, when the Terrorism Risk Insurance Act of 2002 became law. This legislation provides that the federal government will absorb terrorism losses incurred by the property/casualty industry in excess of specified annual amounts, subject to a per company deductible based on premiums written.\textsuperscript{56}

Congress has been largely content to leave day-to-day regulation of the insurance industry largely in the hands of the states. However, when widespread unavailability or unaffordability of insurance adversely affects the national interest it has not hesitated to put a federal program in place.

\section*{B. Insurance in the Context of Financial Services}

\subsection*{1. Overview}

Insurance is one of the three components of the financial services industry. The other two are banking and securities. These businesses were once largely separate and distinct, but competitive pressures, legislation and litigation have combined to bring about increasing homogenization. Today, it is impossible to fully understand the business strategies of insurance companies or the actions of insurance regulators without some knowledge of how the insurance, banking and securities businesses interact. The convergence of the three branches of the financial services is discussed in Chapter Eleven.

\begin{itemize}
\item \textsuperscript{49} See 20 U.S.C. 1071-1089.
\item \textsuperscript{50} See 15 U.S.C. ch 14A.
\item \textsuperscript{51} See 22 U.S.C. 2197.
\item \textsuperscript{52} See 33 U.S.C. 901-950. Congress enacted this program in response to Supreme Court decisions precluding the applicability of state workmen’s compensation laws to maritime workers even when such application was sanctioned by federal law. See \textit{Knickerbocker Ice Co. v. Stewart}, 253 U.S. 149, 164 (1920); \textit{Washington v. W.C. Dawson}, 264 U.S. 219, 228 (1924).
\item \textsuperscript{53} See 42 U.S.C. ch. 50.
\item \textsuperscript{54} See 7 U.S.C. ch. 36.
\item \textsuperscript{55} See 46 USC 53901.
\end{itemize}
The three branches of the financial services industry have important common characteristics. All three are subject to comprehensive regulatory schemes that seek to maintain the financial viability of the regulated entities while at the same time championing the interests of consumers—two objectives that are not always compatible. Despite the best efforts of the regulatory agencies, insolvencies do occur. Insurance systems designed to cushion the impact of failures on customers exist for all three industries. One major difference among the regulatory schemes is the locus of control. Federal agencies are the lead regulators for the banking and securities industries, but the state regulators play the predominant role in insurance regulation.

The financial service industry sells hundreds of products. There are plain vanilla items like thirty-year fixed-rate mortgages, term life insurance policies and hundred share lots of IBM stock. At the opposite end of the complexity spectrum are interest rate swaps, experience rated workers’ compensation policies covering multiple employer groups and put and call options. Despite their profusion, all financial service industry products perform one or more of the following functions: (1) providing credit, (2) underwriting, dealing in, or making a market in, securities, (3) providing investment advice or handling the investment of money, (4) executing, as agent, transactions involving the payment or transfer of money or the purchase or sale of securities, (5) insuring, guaranteeing or indemnifying against liability, property damage, financial loss, personal injury, the need for medical services or death, or acting as agent for the sale of products that provide such protections, and (6) issuing contracts for the payment of money or acting as an agent or broker for the issuance of such contracts. All three segments of the financial services industry sell products that perform these five functions. Many of those products compete directly with the same product or a functionally equivalent product offered by other segments of the industry. Loans are thought of as a banking industry product, but life insurance companies make loans against the security of life insurance policies and are important players in commercial real estate lending. Securities firms make margin loans against the securities owned by their customers. All three branches of the industry provide investment advice and money management services for their customers. Life insurance companies, banks, securities broker/dealers and mutual funds compete vigorously for IRA accounts. An investor seeking a long term, non-speculative investment offering a fixed rate of return can choose among a long-term bank CD, a fixed annuity and an AAA-rated corporate bond purchased through a broker.

2. Structure and Performance

The banking industry consists of a variety of entities—federal and state-chartered commercial banks, savings banks, savings and loan associations, and credit unions, as well as, bank holding companies and thrift holding companies. At year-end 2013, the nation’s commercial banks and savings institutions had total assets of $14.7 trillion.57

An important secular trend in the banking industry has been the decrease in the industry’s share of the total credit market and an increase in the percentage of its income that is derived from deposit account charges, securities trading, fiduciary activities and other fee generating lines of business.\textsuperscript{58} This shift has pluses and minuses. The fact that borrowers can obtain credit from a number of other sources has reduced the banking industry’s market power and made lending less profitable. It has also made it harder for banks to leverage their position as the source of credit to sell other products. On the other hand, banking industry over-dependence on earnings generated by lending activities has historically led to cyclical over expansion of credit coupled with weakened underwriting standards. The result has been periodic banking/credit availability crises. The sub-prime mortgage debacle is the latest in the series.

One of the competitive strengths of the banking industry is its distribution system consisting of 100,000 bank branches and 425,000 ATMs.\textsuperscript{59} While these facilities represent a major expense item, they give the banking industry a powerful tool for interfacing with, and selling products to, its customers.

The largest segment of the securities industry consists of investment companies—mutual funds, closed end funds, exchange traded funds and unit investment trusts.\textsuperscript{60} Investment bankers and broker/dealers are also part of the industry. Collectively these entities facilitate the flow of funds from investors to companies that seek capital for startup, ongoing operations or expansion. Investment bankers underwrite new debt and equity issues, buying the securities at wholesale from the issuer and then marking them up and selling them to investors through a retail distribution system. Brokers act as part of the distribution mechanism for new issues of securities, including mutual fund shares. Brokers also act as intermediaries between buyers and sellers of securities that have already been distributed into the marketplace, charging a fee for each transaction executed. Brokerage houses may buy and sell securities for their own account, making a profit by selling at a “spread,” a price that is slightly higher than that at which they purchased.

Mutual funds are open-end investment companies. Their shares are distributed by broker/dealers (some of whom are affiliated or banks and insurance companies) that generally earn a fee for each sale. Investment advisors provide mutual funds with advice on their purchases of individual securities and on portfolio strategy. The net assets of mutual funds grew from $495 billion in 1985 to $11.6 trillion by 2011.\textsuperscript{61}

Money market mutual funds have been one of the fastest growing species of mutual funds. The fact that individuals can write checks against their money market mutual fund accounts, makes them competitive with bank deposit accounts.

The property/casualty and life insurance industries had combined assets of $8.4 trillion at year-end 2014.\textsuperscript{62} The fact that the rates for many important

\textsuperscript{58} See id. at120-121.
\textsuperscript{59} See id. at 120, 195.
\textsuperscript{61} See Insurance Information Institute and Financial Services Roundtable, supra note 57, at 160-161.
property/casualty products such as auto and workers’ compensation insurance are subject to approval by state insurance regulators restrains profitability. On the positive side, state insurance laws mandate that drivers must carry auto insurance and that most employers must carry workers’ compensation insurance. Furthermore, state insurance regulators zealously use their authority to prevent the sale by non-insurance companies of insurance-like products that are competitive with traditional insurance products.

The general freedom from solvency problems and positive earnings trend that had been the norm for the financial services industry at the beginning of the 21st century ended in 2006. Earnings in the banking and securities sectors deteriorated severely in 2007. The year 2008 brought a full-fledged crisis that affected all three branches of the industry.

EXHIBIT 1
PROPERTY/CASUALTY INDUSTRY ANNUAL INCOME STATEMENTS ($ billions)

<table>
<thead>
<tr>
<th></th>
<th>Average Yr.</th>
<th>Bad Yr.</th>
<th>Fantastic Yr.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2009</td>
<td>2001</td>
<td>2006</td>
</tr>
<tr>
<td>1. UNDERWRITING OPERATIONS</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Earned Premiums</td>
<td>$423</td>
<td>$312</td>
<td>$435</td>
</tr>
<tr>
<td>Expenses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Losses Paid</td>
<td>$254</td>
<td>$235</td>
<td>$231</td>
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<tr>
<td>Loss Adjustment Expenses</td>
<td>53</td>
<td>41</td>
<td>53</td>
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<tr>
<td>Other Underwriting Expenses</td>
<td>119</td>
<td>89</td>
<td>120</td>
</tr>
<tr>
<td>Total Underwriting Expenses</td>
<td>$426</td>
<td>$366</td>
<td>$404</td>
</tr>
<tr>
<td>UNDERWRITING GAIN/LOSS</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>COMBINED RATIO</td>
<td>-$3</td>
<td>-$53</td>
<td>$31</td>
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<tr>
<td></td>
<td>101</td>
<td>115</td>
<td>93</td>
</tr>
<tr>
<td>2. INVESTMENT OPERATIONS</td>
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<td></td>
</tr>
<tr>
<td>Div. &amp; Int. Income. Net of Expenses</td>
<td>$48</td>
<td>$38</td>
<td>$52</td>
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<tr>
<td>OPERATING INCOME/LOSS</td>
<td>$45</td>
<td>-$14</td>
<td>$83</td>
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<tr>
<td>3. NON-OPERATING ITEMS</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Realized capital gains/losses</td>
<td>-$8</td>
<td>$7</td>
<td>$4</td>
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<tr>
<td>Federal income taxes/credits</td>
<td>-$9</td>
<td>$0</td>
<td>-$24</td>
</tr>
<tr>
<td>Total of NOIs</td>
<td>-$16</td>
<td>$7</td>
<td>-$20</td>
</tr>
<tr>
<td>NET INCOME AFTER TAXES</td>
<td>$28</td>
<td>-$7</td>
<td>$64</td>
</tr>
</tbody>
</table>