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THE LAST THIRD OF THE 20TH CENTURY :  
CHALLENGES TO THE INSURANCE INDUSTRY

By

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By Karl R. Bopp

I am very happy to be with you today. I am particularly intrigued by the long-run focus of your seminar. It is a refreshing diversion to look beyond the pressing problems that confront our financial structure today in order to examine some of the major forces that will be shaping your industry through the remainder of the century.

At the outset I should warn you that I am not a forecaster. I have neither a reliable crystal ball nor a handful of wise tea leaves. Were I to have made specific forecasts thirty years ago, I would have missed economic and financial conditions prevailing today by a very wide mark indeed. Who would have predicted in 1939 that our Gross National Product would jump from \$90 billion to over \$900 billion today? Who would have anticipated the development and sophistication of today's financial markets?

Rather than attempt to predict the future, therefore, I should like to ask a few questions--which I believe you in the insurance industry should consider as you make your long-run plans. As I try to visualize the challenges which will confront you, I see them falling into three broad categories:

- (1) those that stem from what now seems to be an inflationary bias of the economy;
- (2) those that come from your attempts to meet competition; and
- (3) those that are associated with a changing political and social environment.

I should like to raise questions about each of these and explore some of their implications.

Inflationary bias

When asked to predict stock prices, J. P. Morgan once responded, "The market will fluctuate." We can understand the dismay of Morgan's inquirer who longed for some profitable tip. When I look at the future objectively as a central banker, I, too, must conclude that the safest assumption is that the economy will fluctuate. I find no evidence that business fluctuations have become a phenomenon of the past. Rather, it appears that so long as we enjoy the freedom to make our own spending and investment decisions economic activity is likely to continue to ebb and flow.

Beyond this not very helpful conclusion, however, let me explore some other possibilities. What, for example, is the likelihood that economic fluctuations will be less violent than in the past? Some arguments can be made for this position. If they are valid, they certainly have great significance for the future of the insurance industry.

One is that the composition of the economy is shifting in a way that will produce greater stability. Services are becoming a growing part of our economy relative to goods-producing industries. In 1937, services accounted for 38 per cent of total non-government employment; they are now responsible for about 48 per cent. The insurance business, of course, is itself part of this trend and will participate in any further shifts. Although economists comprehend less than they would like to know about this phenomenon, they generally conclude that this shift in composition will help to lend stability to the economy.

The fact that Government accounts for a larger share of economic activity also may tend to add stability of a sort, although at times Government expenditures fluctuate substantially. Certainly, there is no evidence to indicate that Government will readily cut programs or payrolls in the future any more than it has in the past.

And, finally, it may be that we have learned something about how to manage the economy. Slowly and painfully, economists are pushing out the frontiers of knowledge. By trial and error with monetary and fiscal tools, we are learning which old mistakes not to repeat. And although new mistakes will be made in coming years, it is possible that we shall do a better job in stabilizing the economy than we have in the past. I have hopes, but not a great deal of certainty.

In calculating the odds for the coming decades, therefore, the insurance industry must give some weight to the possibility that it will live in an economy less subject to the kinds of fluctuations experienced in past decades. I join you in hoping that these odds pay off.

But you must also weigh the odds that the economy will experience primarily a one-way "stability"-- that it will suffer from an inflationary bias. In considering this possibility, it is difficult, of course, to divorce one's thinking from what is going on right now. Beyond the current scene, what case can be made for the inflation thesis?

Basic to the argument is that our society has become intolerant of recessions. The Employment Act of 1946 was a landmark in this country's economic history. It was the direct product of the Great Depression. It pledged Government to the maintenance of maximum income, employment, and purchasing power. But it made no mention of the price level as such.

You may well question, as I do, why society should put so much stress on the social costs of unemployment and so little on the social costs of inflation. The latter, of course, are less apparent, but no less real. It may be that society will shift its view of the relative costs, but I would not advise you in the insurance business to count heavily on it.

Even if you were to be optimistic on this score, there are other arguments for the inflation hypothesis. One is the rigidity that has been

built into our wage structure, a rigidity that permits wages to rise but which resists declines. Another is that the very shift from goods-producing industries to services that may add stability to the economy may also add to inflation because it is so hard to increase productivity in many of these services. Since World War II, prices of services have increased 1.6 times as fast as prices of commodities.

And, finally, there is the argument that we, in fact, have had rising prices most of the time in the past twenty years. On the average, consumer prices have risen at a compound rate of 1.875 per cent a year. It is possible that this will not be the pattern for the next thirty years, but I would not recommend that the insurance industry put all its long-run plans in that basket.

Assuming, for purposes of argument, that the inflation thesis is the correct one, what are the implications for insurance? Increasingly, ordinary life policies are being shunned by "sophisticated" individuals who assume some rate of inflation in making their saving and investment decisions. The fear that inflation will erode benefits of ordinary life policies has prompted growing numbers of people to buy term insurance for protection against death and to channel savings to other investments which they think will be less adversely affected by inflation.

Life insurance reserves have become a declining proportion of the total financial assets of consumers in the United States. From 1945 through 1967, life insurance reserves of households grew by 193 per cent while corporate stock at market value jumped by nearly 560 per cent. Of course, much of the latter represented capital gains, not amounts of new money; but that is precisely the point! Pension fund reserves soared 1,737 per cent during the same period.

It is clear that in their fear of inflation households are channeling larger proportions of their savings into financial assets other than life insurance. Even if chronic inflation is an inaccurate forecast for the next few decades, how long will it take to convince people that they need no longer protect themselves against it?

Is it not possible, therefore, that whether the inflation thesis is valid or not, we face a future in which financial decisions will be greatly dominated by a desire to protect oneself against inflation? This certainly seems to be the basis on which insurance companies are acting today.

As inflationary pressures have mounted, insurance companies have found themselves lending more and enjoying it less. Consequently, they have put increasing emphasis on equity investments in their portfolios-- not just common stock of major corporations but also "pieces of the action" in shopping centers and other projects for which they have provided mortgage funds.

An intriguing question is what may happen to the basic function of insurance companies in a world of inflation-hedgers. Rather than spreaders of risk will insurance companies become creators of risk? Greater emphasis upon equity-type assets which tend to increase in value during inflationary periods may help to sustain the total value of insurance companies' assets at a time of inflation when prices of fixed-income assets are declining. In this case, equity investments may, in the future, help insurers as well as their customers to find a bit more security. But is it also possible that if insurance companies become motivated by the "cult of performance" they will help to make financial

markets less stable? If so, they may be creating additional risk and uncertainty.

Finally, what kind of an economy would we have when everyone-- savers, investors, management, labor-- is trying to protect himself against inflation? I confess I can see only some of the outlines of it very dimly. In the first place, would there not be a great deal of unproductive time and effort diverted to this pursuit? Secondly, could anyone succeed equally well; could everyone win this game of musical chairs? And, if by chance everyone did succeed, what would have been gained? Would anyone be better off than if there had been no inflation in the first place?

The insurance industry has a great stake in economic stability. And although I can understand your concern about inflation and attempts to protect yourself against it, I urge you to do all that you can to prevent it.

## Competition

A second major challenge facing insurance companies in the years ahead has to do with competition. This certainly is not a new challenge; yet its nature may be substantially different than in the past. In addition to competition which has been increasing among insurance companies, the industry may well face major new sources of competition from many other types of specialized financial institutions.

This trend toward greater inter-industry competition is already well under way. In mortgage markets, the old competitors are hard at it. In an effort to compete more effectively, mutual savings banks, for example, are engaged in a struggle to secure federal chartering, thus opening new geographical frontiers for expansion.

In the consumer lending field, efforts are under way by organizations of savings banks and savings and loan associations to secure statutory and regulatory permission to make consumer loans. Moreover, life insurance companies involuntarily are making more loans against cash value of policies and thereby competing in the consumer loan market as well as in the mortgage market.

Commercial banks are actively preparing to move into many new kinds of business--the specific kinds depending on the outcome of Congressional deliberations now under way--through one-bank holding companies.

The life insurance area is not sacrosanct either. Mutual savings banks in New York, Massachusetts, and Connecticut have long been active in the field, and creation of the Savings Bank Life Insurance Company of Connecticut has made possible the extension of savings bank life insurance to other states as well.

Mutual funds, long the principal institutional vehicle through which

individuals could participate in equity investments, increasingly will be feeling the heat of new competition from variable annuity policies, from funds sponsored by insurance companies, and from commingled trust funds at savings and loan associations and commercial banks.

What is the basic force behind this broader scope of competition? Primarily, I believe, it is the desire of the various institutions to break out of contracting or confining specialized markets. Managers of financial institutions fear that in a rapidly changing economy their area of specialization may not always continue to grow adequately. They believe that as multi-celled institutions they may be better able to adapt to changes in the environment than as uni-celled institutions. Damage to a single cell poses less danger to the whole institution. Security, stability and growth require a more complex structure. Therefore, financial institutions are becoming more complex through diversification into new areas and expansion of their base of operations.

A major question for the future will be how far and how rapidly the insurance industry will move in responding to the challenge of greater competition by stepping up its own efforts to diversify. A survey of life insurance companies conducted by Financial Research Associates last fall revealed that about 40 per cent of the respondents were offering or planning to offer mutual fund shares, and a small proportion were offering or planning to offer variable annuity policies.\* This may be just the beginning of diversification efforts of insurance companies. Perhaps the trend will accelerate in the years ahead.

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\* "Equity Related Plans of Leading Life Companies" published as a supplement to Life Insurance Stock Letter, Denton, Texas: Financial Research Associates, October, 1968.

A second question is the vehicle which insurance companies will use for diversification. Among insurance companies, as among commercial banks, the holding company device apparently is in vogue. About a quarter of the leading life insurance companies are reported to have holding companies in operation and another 15 per cent are planning to set up such companies. The remaining three-fifths are equally divided between those studying the vehicle and those having no present plans to expand via the holding company route.

Although the kind of competition I have described is not new to you, the intensity and variety of it in coming decades will, I believe, surprise us all. As an economist, I look forward to it as a means of broadening markets and providing better services. Although it will bring you many problems, these are the kinds of problems you should welcome.

#### Political and social environment

Answers to the questions I have raised will depend greatly on the answer to a still more difficult question: what will be the political and social environment in which insurance companies will be operating?

Will social pressures continue to stress the costs of unemployment over the costs of inflation? Will political expediency emphasize economic growth even though much of that growth is merely an inflated dollar? Your assessment of these possibilities will be important in weighing the likelihood of chronic inflation in the decades ahead.

As for competition, will Government provide an environment in which financial institutions will be freer to move into new kinds of business? The decisions which Congress makes on one-bank holding companies may soon give you a clue.

I wish I could give you optimistic answers to these questions, but my vision of the future is blurred; my observation of the past does not give me reassurance. But the future is something you can help to shape, and perhaps this is the biggest challenge you face. You can help to bring about the kind of political and social environment conducive to broad and vigorous competition and to economic growth without inflation.

One final question: what role will insurance companies play in improving the quality of life for the disadvantaged in our society? In recent years we have experienced mounting concern with human values. Unemployment statistics are no longer just numbers; they represent unfulfilled lives and washed-up dreams. In response, business--with the insurance industry in the forefront--is considering a new set of priorities.

Can the insurance industry afford to emphasize short-run profit at the expense of long-run survival? This is what you have been asking yourselves as you confront the mess in our cities and the conflicts among groups of our society. Your answer is a resounding "no." I am confident it will be an even more vigorous "no" in the decades to come.

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