

*The Discounted Cash Flow Approach*

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*Insurance Profitability*

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*Review by Robert P. Eramo*

The authors provide an excellent presentation of their respective views. Their debate clearly is between viewing return on surplus or return on premium as the most appropriate measure of return. This is a debate of importance to more than the insurance industry. Utilities in this country have been subjected to rate regulation for years, and the decision to approve utility rates is frequently based on factors similar to those in the authors' papers. When surplus and premium are substituted with equity and sales, respectively, one clearly sees the application to other industries.

It is important to realize that most businesses experience periods in their history when market conditions permit unusually high rates of return. These conditions may result from the newness of a product or internal efficiencies permitting a high rate of return. In a free market, high rates of return can be a key factor motivating the promotion and development of new products and services. Governments and government regulators should do little to discourage rapid development induced by high rates of return.

It is probably not the authors' intent to provide regulators ammunition that stifles innovation and progress. Unfortunately, these papers may be read by populists seeking political gain. Resulting pricing constraints, strictly driven by the factors covered by these papers, can stifle innovation and progress. The retardation of progress in the long run hurts all of us.

Specifically, in the property and casualty insurance industry, certain insurance companies have presented in certain periods of their history their stockholders with extraordinarily high rates of return. These high rates of return can be justified in most instances. The movement to direct sale of personal lines insurance is one example. If rigid regulation had been applied to companies making the move to direct sales, all consumers would have suffered paying insurance rates higher than necessary. Other property and casualty companies have innovated in the commercial lines, benefiting from the minimal rate regulation prevalent in the commercial lines. The massive movement to self insurance has been facilitated by a revolution in fronting arrangements spear-headed by certain property and casualty companies. Both business and consumers benefit with the ability to buy risk management services from a number of third party administrators. The risk management program is specifically designed, and prices are negotiated at a number of levels by the insurer.

In conclusion, both authors provide fine studies on the rate-of-return question. But one must never suggest that factors treated in these papers become the sole determinant of an appropriate price. In business, those who innovate must be rewarded. And the value of the innovation is frequently not easily quantifiable and reflected in some ratemaking formula. If a regulator limits his decision making to known historical factors in his approval procedures, in the long run, all will suffer paying higher prices and receiving services less than what technology permits.

Government regulators must recognize the need for high rates of return at critical points of economic development. Most importantly, regulators must realize that over time innovations are copied, eventually causing both prices and rates of return to fall to more normal levels. The regulator best meets his goal of reducing excess profits by encouraging competition, not by brow beating innovators. Regulation that caters to "price controls" makes everyone lose. It will be tragic if these fine papers serve as fodder for regulation that stifles innovation and that limits the workings of a free market.