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Consumer Federation of America

January 23, 2018

To: Insurance Commissioners
50 states and the District of Columbia

Immediate Rate Reductions Needed Now to Reflect Lower Federal Taxes Resulting in Excessive Profit Provisions in Current Rates

Dear Commissioner:

We write to request your immediate action to require insurers to file lower rates to reflect the federal tax legislation passed by Congress late last year and effective for 2018 forward. We call your attention to the fact that, in another regulated industry, many utility companies have already announced plans to cut rates due to the "expected windfall they plan to receive when corporate taxes are cut."[1]

The changes in the tax law dramatically reduce federal corporate tax rates, which has a direct impact on insurer profitability. The components of an insurance rate include claims, claim settlement costs, sales expenses, general and administrative expenses and a provision for profit. The profit provision is developed, generally, by taking the target after-tax rate of return, grossing it up to a before-tax rate of return, converting the return on capital to a percentage of premium and offsetting the indicated profit as a percentage of premium by expected investment income. So, if the target after-tax rate of return is, say, 10%, the before-tax rate with a 35% corporate tax rate is 15.4%. When the tax rate dropped to 21%, the before-tax rate used in developing the profit provision would drop to 12.7%. In addition, after-tax investment income may be taxed at a lower rate, further increasing the profit provision at current rates.

Since the profit provision is treated as a variable expense, the impact of the reduced tax rates on profitability is significant – with our example above, rates should decline by about 5%[2] without including the impact of more investment income due to lower taxes on that income. The impact on profitability – and the relatively large indicated rate reduction – will be even greater with higher target after-tax rates of return and for longer-tail lines with greater investment income.

On a property-casualty industry wide basis, the windfall to insurers from the tax changes are massive. 5% of the $ 539 billion in premiums collected is over $25 billion. For longer-tailed lines, like medical professional liability, the increase in investment income on reserves and surplus will be much greater than average because of the reduction in tax rates.

1 *Washington Examiner*, January 9, 2018.

2 Based on 60% claims and fixed costs and 40% variable costs, a reduction of 3% in variable costs would produce an indicated rate reduction of 4.8%. For ease of illustration, the premium to surplus ratio used is 1:1.

The changes to the tax laws also call into question the wisdom of the changes made by the NAIC a few years ago extending the period of time for evaluating deferred tax assets. Recent reports indicate massive reductions for many insurers in deferred tax assets suggesting these so-called assets were illusory.

Based on the above, we ask your response to the following questions:

1. What is your evaluation of the recent changes in tax laws on insurer profitability by line and what is the basis for your conclusions?
2. What actions are you taking in the next month to cause insurers to reduce rates to reflect the windfall from tax changes and to ensure rates return to not excessive levels?
3. Will you support an effort by the NAIC to revisit the changes made to accounting for deferred tax assets from a few years ago?

Please send your responses to mstyczynski@consumerfed.org

Sincerely,

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