

Insurance Regulation: The Need for Policy Reform

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Abstract

This paper discusses needed reforms in US insurance regulatory policies. There is a fierce, ongoing debate about restructuring the institutional framework for insurance regulation. A significant proportion of the industry supports the creation of an Optional Federal Charter (OFC) for insurers that would preempt state regulation for federally-chartered companies. The states and other segments of the industry strongly oppose an OFC. Equally as important but somewhat less visible is the need for reforming many current insurance regulatory policies to reduce costs and promote more efficient markets. Policy reforms are warranted regardless of how the institutional framework for insurance regulation evolves, recognizing that the prospects for reforms may vary with the institutional structure that is established. Indeed, OFC proponents envision that it will create a platform for more rational regulation. At the same time, the creation of an OFC will still leave an “optional” state regulatory framework in place and the states will need to consider their policies to promote the efficiency of the insurers and markets they continue to regulate. Hence, an evaluation of insurance regulatory policies is valuable to guide both federal and state authorities as institutions change. We identify and evaluate the most significant policies in the principal areas of financial oversight, market regulation and antitrust. Our evaluation considers the principles that should guide how insurance is regulated as well as the issues associated with specific policy reforms and their implications. We also comment on the prospects for reforms under different frameworks.

I. Introduction

As the insurance industry has evolved its support for state regulation has eroded. Many insurers now support the creation of an Optional Federal Charter (OFC) for insurers that would preempt state regulation for federally-regulated insurers and intermediaries. The industry’s limited antitrust exemption also would be modified. An insurance OFC has also been incorporated as an element of the Treasury’s blueprint for revamping the regulatory structure for all financial institutions (Department of the Treasury, 2008). OFC proposals are strongly opposed by the states as well as certain industry groups (e.g., independent agents) with a vested interest in preserving the existing system. Hence, a fierce debate continues over the restructuring of the insurance

regulatory framework and its policies. This debate is occurring in the context of a broader dialogue about alternative regulatory frameworks for insurance, although an OFC is receiving the greatest attention and appears to have the greatest political impetus.¹

Beyond the push for increasing the federal role in insurance regulation, there are strong pressures for reforming insurance regulatory policies. Indeed, proponents of an OFC envision that federal regulators would embrace a set of policies that they would prefer. At the same time, the creation of an OFC would still leave an “optional” state framework in place and the states will need to reconsider their regulatory policies. Further, the constituency for improving insurance regulation extends beyond OFC proponents to other segments of the industry that continue to advocate a state framework. Many economists also support significant changes in how insurance is regulated. Hence, the drumbeat for policy reforms has been strong and growing for some time. Further, they remain relevant regardless of how the institutional framework for insurance regulation evolves.

This paper discusses needed reforms in US insurance regulatory policies in critical areas. An assessment of insurance regulatory policies is valuable to guide both federal and state authorities as institutions change. We identify and evaluate the most significant policies in the principal areas of financial oversight, market regulation and antitrust. Our evaluation considers the principles that should guide how insurance is regulated as well as the issues associated with specific policy reforms and their implications. We also comment on the prospects for reforms under different frameworks.

¹ See Grace and Klein (2008a) for a summary discussion of other frameworks that have been proposed or discussed. For example, it is possible that an OFC for life insurers will be enacted before it is extended to property-casualty insurers.

Our paper is organized as follows. Section II articulates a basic set of economic principles that should guide the regulation of insurance and any changes to it. Sections III, IV and V evaluate regulatory policies in the areas of solvency, market conduct and antitrust respectively. Section VI summarizes and concludes our analysis.

II. Economic Principles for Insurance Regulation

A. The Rationale for Insurance Regulation

The economic foundation for industry regulation is based on the possibility (or realization) of market failures (see, for example, Spulber, 1989; Viscusi, Harrington and Vernon, 2000). These market failures are judged against the social welfare maximizing conditions for perfect competition. Perfect competition requires many buyers and sellers in a market, free entry and exit, perfect information, and a homogenous product. Under these conditions, the joint surplus or gains from trade of producers and consumers is maximized. In assessing the need for and benefits of regulation in an imperfect world, markets are often judged against a standard of “workable competition” which reasonably approximates the conditions for perfect competition to the degree that government intervention cannot improve social welfare (Scherer and Ross, 1990).

Potential market failures in insurance include severe asymmetric information problems and principal-agent conflicts which could lead some insurance companies to incur excessive financial risk and/or engage in abusive market practices that harm consumers.² Insurance consumers, particularly individuals and households, face significant challenges in judging the financial risk of insurers and properly understanding the terms of insurance contracts. Consumers also could find it difficult to compel insurers

² Skipper and Klein (2000) articulate principles for insurance regulation in an international context.

to fulfill their obligations under their contracts. Further, there is the remote possibility that insurers could acquire sufficient market power to restrict competition, resulting in barriers to entry, higher prices and excessive economic profits.

Beyond market failures, there are a set of circumstance we term “market problems.” These are not failures in the economic sense but constitute “undesirable” market outcomes, e.g., high prices, the unavailability of insurance coverage, etc., that result from conditions affecting the cost and of risk rather than violations of the conditions for perfect or workable competition. For example, in some markets insurance may be expensive because claim costs are high. While this may cause hardships for consumers, it is a natural result of properly-functioning market forces and not a condition that can be remedied by regulation per se. Unfortunately, many existing regulatory policies are motivated by a desire to alleviate market problems rather than to remedy true market failures.

The rationale for government intervention when a market failure occurs is that regulators can remedy the failure and restore economic efficiency. In the case of solvency or financial regulation of insurance companies, one could argue that the costs of monitoring are so high for consumers that it is cheaper for the government to undertake this task and take action against insurers that incur excessive financial risk.³ If it is more efficient for the government to perform this monitoring and undertake other compliance/enforcement measures, then regulatory intervention is welfare-enhancing. It can also be argued that the scope and stringency of financial regulation can be tempered by reliance on “market discipline” in sectors where buyers have the incentives and ability

³ Harrington (2004) outlines principles for efficient financial regulation of insurance companies.

to identify financially sound insurers (Harrington, 2004). Regulators can facilitate market discipline by compelling the transparency of insurers' financial condition and risk.

Optimal regulation is based upon an ideal set of policies that attempt to replicate the conditions of a competitive market and maximize social welfare. This theoretical model of regulation is primarily intended to remedy market failures and not market problems caused by other external forces. This may include failures that would otherwise cause insurers' to incur an excessive risk of insolvency and/or engage in abusive trade practices, e.g., misrepresenting insurance products, refusing to pay legitimate claims, etc. This assumes that regulators have perfect information and can determine and implement the correct market solutions. However, not all market failures can necessarily be remedied by regulation.

1. Solvency Regulation

The social welfare argument for the regulation of insurer solvency derives from inefficiencies created by costly information and principal-agent problems (Munch and Smallwood, 1981). Owners of insurance companies have diminished incentives to maintain a high level of safety to the extent that their personal assets are not at risk for unfunded obligations to policyholders that would arise from insolvency. The argument is that it is costly for consumers to properly assess an insurer's financial strength in relation to its prices and quality of service. Insurers also can increase their risk after policyholders have purchased a policy and paid premiums – a “principal-agent” problem that may be very costly and difficult for policyholders to control.

While this kind of problem may exist in many industries, certain financial institutions with significant fiduciary responsibilities – specifically banks and insurance companies – are viewed in a special light.⁴ The fact that they receive and hold funds to fund future obligations to their customers increases the costs of asymmetric information problems and principal agent conflicts. The long-term nature of many of these obligations and the large amounts of funds involved contribute to solvency concerns. Historically, the adverse consequences of bank and insurer bankruptcies in the absence of government oversight and protections have prompted regulatory responses. Today, the regulation of financial institutions is well-established in most if not all developed economies with mature financial markets.

There are other aspects of excessive insolvency risk that may motivate regulatory intervention. Financial regulators are also concerned about “contagion” and the possibility that a spike in insurer insolvencies could induce a “crisis of confidence” that may have negative effects on the industry.⁵ Further, there may be negative externalities associated with excessive insurer insolvency risk. The costs of unpaid claims may be shifted beyond policyholders to their creditors. Hence, it is common for the regulation of financial institutions to be coupled with some form of insolvency guarantees (e.g., deposit insurance, insurance guaranty associations, etc.) that cover at least a portion of the obligations of bankrupt institutions.

The goal of optimal insurance solvency regulation is not to eliminate insolvencies but rather to minimize or limit the social cost of insurer insolvency within acceptable

⁴ Saunders and Cornett (2003) discuss the rationale for the regulation of financial institutions. While their principal argument is based on externalities (discussed below), other arguments contribute to the case for government oversight.

⁵ Some might argue that the life insurance industry was on the brink of such a crisis in the late 1980s when there was a spike in insolvencies due to asset problems.

parameters (Grace, Klein, and Phillips, 2002a). This social cost is more than merely the lost equity of the insurer; it includes the effects on policyholders and third parties who may be creditors of insurers. Regulators limit insolvency risk by requiring insurers to meet a set of financial standards and taking appropriate actions if an insurer assumes excessive default risk or experiences financial distress (See, for example, Cummins, Harrington, and Klein, 1995).

2. Price Regulation

There are two potential rationales for regulation of insurance prices. The traditional explanation for regulation of insurance prices involves costly information and solvency concerns (Joskow, 1973; Hanson, Dineen, and Johnson, 1974). According to this explanation, insurers' incentive to incur excessive financial risk and even engage in "go-for-broke" strategies may result in inadequate prices. Some consumers may buy insurance from carriers charging inadequate prices without properly considering the greater financial risk involved. In this scenario, poor incentives for safety could induce a wave of "destructive competition" in which all insurers are forced to cut their prices below costs to retain their market positions.⁶ Historically, the solution offered was uniform prices developed by industry rating organizations subject to regulatory oversight to prevent excessive prices.

This view essentially governed insurance rate regulation until the 1960s when states began to disapprove or reduce price increases in lines such as personal auto and workers' compensation insurance. The rationale that some might offer for government

⁶ This view likely stems from the periodic price wars (and subsequent insurer failures) that afflicted property-casualty insurance markets during the 1800s and early 1900s.

restrictions on insurance price increases is that consumer search costs impede competition and lead to excessive prices and profits.⁷ It also might be argued that it is costly for insurers to ascertain consumers' risk characteristics accurately, giving an informational advantage to insurers already entrenched in a market and creating barriers to entry that diminish competition. According to this view, the objective of regulation is to enforce a ceiling that will prevent prices from rising above a competitive level. In addition, the public may express a preference for regulatory policies to lower or cap insurance prices consistent with social norms or objectives.⁸

However, the empirical evidence does not support a case for the regulation of insurance prices in the current environment. Studies of insurance markets indicate that they are highly competitive in terms of their structure and performance (Cummins and Weiss, 1991, Klein, 1995 and 2005, and Grace and Klein, 2007). Entry barriers are generally low and concentration levels rarely approach a point that would raise concerns about insurers' market power. Further, long-term profits in insurance markets tend to be in line with or below the rates of return earned in other industries (Insurance Information Institute, 2008). We should also note that over the last 50 years, enforcement of uniform rates has eroded and industry organizations have moved to the promulgation of "advisory" rates or loss costs. Consequently, insurer pricing has become much more independent and differentiated. Hence, it is not surprising that studies of the effects of the regulation of insurance rates have not uncovered significant benefits to consumers (see, for example, Harrington, 2002).

⁷ Harrington (1992) explains but does not advocate this view.

⁸ For example, most states have determined that drivers should carry some form of liability or no-fault auto insurance. Because of this requirement, some policymakers believe that the government should ensure that insurance coverage is reasonably available and affordable for those who are required to purchase it. This argument has been used to justify strict controls on auto insurance rate increases in some jurisdictions.

3. Market Conduct Regulation

A stronger case can be made for regulating certain insurer market practices, such as policy forms (contracts), marketing and claims adjustment. Information problems, constraints on consumer choice and unequal bargaining power between insurers and consumers can make some consumers vulnerable to abusive marketing and claims practices of insurers and their agents.⁹ For example, many life insurers were sued and sanctioned in the late 1980s and early 1990s for agent practices which took customers out of safe policies and put them in inappropriate (high-risk) policies.¹⁰ Although prominent insurers were involved in some of these cases, the greater threat probably lies with firms or agents that are not highly motivated to establish and maintain a strong reputation for fair dealings with consumers. Hence, regulators need to be especially vigilant for “bad actors” that seek gains from abusive or fraudulent transactions. Government regulation may be complemented by industry self-regulatory organizations (SROs), such as the Insurance Marketplace Standards Association (IMSA) that has been established by life insurers.¹¹

4. Externalities

It is possible that some risks are uninsurable by private insurers without government assistance. The undersupply of insurance in such circumstances could create

⁹ It is true that consumers subject to unfair treatment might seek remedies through the courts and sometimes do so. However, legal remedies may not be feasible for consumers with limited resources and bills to pay. Also, it may be difficult to secure financial damages from some fraudulent insurers.

¹⁰ What is interesting about this example is that the sale practices were not discovered by regulators until after the initial lawsuits were brought.

¹¹ Evidence suggests that IMSA has reduced the costs of market conduct problems while at the same time increasing firm value (see Grace and Klein, 2007).

negative externalities as certain activities may be precluded or compromised because of the lack of insurance for related risks. The government may be better positioned to supply insurance directly or support private insurance by providing reinsurance coverage. This argument has been made to justify federal crop and flood insurance and federal terrorism reinsurance.

In sum, optimal regulation should be designed to minimize the cost of insurer insolvencies, promote competitive, risk-based pricing, encourage reasonable trade practices, provide proper incentives for insurers and agents, and address circumstances where private markets are unable to supply insurance. We evaluate current regulatory policies against this set of principles.

B. Social Preferences and Politics

One can articulate a set of principles that should guide regulatory policies but it is important to recognize that other factors influence the policies that are established and implemented. These factors include social preferences for market outcomes that diverge from those that would result from a competitive market. Other aspects of the politics surrounding certain areas of insurance and their regulation can result in suboptimal policies. The political economy of regulation is characterized by groups vying for policies that favor their economic interests.¹² Some groups may be relatively small but have relatively substantial and concentrated economic interests. They are more likely to prevail on issues that are opaque and not salient to the majority of consumers (Meier,

¹² Insights from Becker (1983) and related literature are helpful in understanding how interest group politics may play in government policies regarding insurance. Stigler (1971) and Peltzman (1976) also laid the foundation for an economic theory of regulatory behavior that considers the potential influence of the concentrated economic interests of regulated firms and other groups.

1988). Other issues, such as the price of auto and home insurance, may be highly salient to many consumers and this could lead to political pressure on regulators to force insurers to offer more favorable terms. Thus, a number of factors could affect regulatory policies in a given area and the beneficiaries of such policies.¹³

Social preferences and interest group lobbying manifested through political choices can influence regulatory and government policies. One example is the attempt to constrain insurance price levels or price differences among different groups of insureds. Such a policy can appeal to consumers if they believe that insurers will otherwise charge excessive prices or they do not understand the basis of risk-based pricing structures. However, price constraints markets can lead to problems of adverse selection as well as moral hazard. Other examples include mandated coverages and laws that require insurers to sell coverage to all applicants which can also have harmful effects. Unfortunately, the negative side of such regulatory policies can be obscured to those who suffer from their consequences. Indeed, there are many circumstances where imperfect public choice mechanisms result in economic outcomes that diminish social welfare and are at odds with voters' long-run economic interests. The tension between economic principles and political realities are relevant to many of the policy reforms we discuss.

III. Solvency Regulation

A. Philosophy and Approach

The approach to overseeing the financial condition and risk of insurance companies should be foremost in any discussion of regulatory policies. This is an area of

¹³ See Meier (1988) and Klein (1995) for discussions of theories of regulatory behavior and how they apply to insurance.

considerable concern as the current US system is outmoded and lagging behind the evolution of the industry and systems employed or being developed in other jurisdictions, such as the European Union (EU).¹⁴ The states have applied a prescriptive or rules-based approach to regulating insurers' financial condition that is heavily influenced by an accounting perspective. This is reflected in numerous laws, regulations, rules and other measures that govern insurers' financial structure and activities. Regulators tend to focus on insurers' compliance with these prescriptions rather than the prudence of their management and actions and their overall financial risk.

The emphasis on an accounting rather than a financial risk view in US regulation, as well as a prescriptive approach, affects insurers' incentives and ability to manage their financial risk. It also affects their efficiency and ability to compete in international insurance markets. Although the number of US insurance company insolvencies have generally declined (see Figure III.1), only part of this trend is probably due to better regulation. Stricter rating agency standards and other industry developments have likely been the primary factors.

Unlike the US, an increasing number of countries (e.g., the UK and other European countries) have employed or are moving toward what might be labeled as a "prudential" or principles-based approach to insurance regulation. In a prudential system, emphasis is placed on insurers' maintaining an adequate "solvency margin" and management competence with an insurer's financial risk being the ultimate point of focus for supervisors. This philosophy is embodied in the EU's collective insurance solvency

¹⁴ See, for example, Klein and Wang (2007) for an assessment and comparison of US and EU insurance financial regulation.

initiatives that set common standards for all EU member countries.¹⁵ It is also reflected in the development of international insurance regulatory standards. These initiatives have been influenced by the Basel II accords for bank regulation but differ in several respects (Shaun and Wang, 2007).

EU regulators tend not to subject insurers to the kind of extensive and detailed set of rules used in the US. Instead, they maintain closer scrutiny of how insurers are managed and exercise greater discretion in the actions or interventions they may employ to correct practices or problems as they deem necessary. Many EU countries have also more quickly embraced a financial/economic approach to insurer regulation than their US counterparts that includes an Enterprise Risk Management (ERM) perspective. This approach allows insurers greater freedom as long as they use that freedom judiciously, do not engage in excessively hazardous ventures or transactions, and ultimately keep their financial risk within reasonable bounds. This more progressive approach to the financial regulation of insurers is embodied in the EU's Solvency II initiative which is scheduled for implementation in 2012-2013.

Virtually every aspect of insurer financial regulation in the US is driven by its prevailing philosophy and approach. Most of the standards that insurers are required to meet are stated in terms of accounting values. Hence, insurers' compliance with these standards is assessed by examining their financial statements and other financial reports they are required to submit. Clearly, the filing of financial statements according to a set of accounting principles is an essential part of any financial regulatory system. The concern is that regulators place too much emphasis on these financial statements and the accounting values reported as well as complying with a detailed set of rules. Accounting

¹⁵ See Eling, Schmeiser, and Schmit (2007) for a more a detailed review of EU solvency initiatives.

values may not provide a true picture of an insurer's financial condition and are inadequate for assessing an insurer's financial risk. Further, an insurer can comply (or at least appear to comply) with all regulatory rules, yet still assume an excessive level of financial risk.

B. Capital Standards

One of the most important elements of the US financial regulatory system – risk-based capital (RBC) requirements – have several limitations which include but are not confined to their reliance on accounting values. RBC requirements are based on a standard formula developed by the NAIC that is both complex and flawed.¹⁶ All of the “charges” used to calculate an insurer's RBC requirement involve the application of selected factors to various accounting values. All but a few companies greatly exceed their RBC requirements which are considerably less stringent than the capital standards set by rating agencies (Klein and Wang, 2007). The low bar set by regulators is reflected in Figure III.2 which compares NAIC capital requirements with those set by A.M. Best (a prominent insurance company rating agency).¹⁷ The imperfections in the US approach have likely compelled regulators to set the bar fairly low to avoid being forced to take actions against insurers that are financially sound. Also, the label “risk-based” is arguably a misnomer because the US does not employ methods that many experts and the most

¹⁶ See e.g., Cummins, Harrington, and Klein (1995), Grace, Harrington and Klein (1998) and Cummins, Grace, and Phillips (1999) for evaluations of the NAIC's risk based capital standards and its early warning systems.

¹⁷ In developing Figure III.2, we divided each insurer's RBC ratio by its Best Capital Adequacy Ratio (BCAR). Both the RBC ratio and the BCAR measure an insurer's actual capital to its minimum capital requirement under the two different systems. Most insurers have a RBC/BCAR ratio that considerably exceeds 200 percent, indicating that their BCARs are significantly lower than their RBC ratios.

progressive regulators believe are needed to assess an insurer's financial risk and the adequacy of its capital (Eling and Holzmuller, 2008).

Currently, US insurers are not subject to any requirements to perform internal risk modeling or allowed to use it as an optional approach to demonstrate the adequacy of their capital and financial risk management. US regulatory standards also have not embraced ERM in requiring insurers to evaluate the full range of risks they face and their interaction. Consequently, regulators do not provide any incentives for insurers to employ internal risk modeling or ERM, although some insurers may still retain internal incentives to undertake these analyses.

US regulators need to move more quickly and radically to revamp their capital standards in line with the development of international regulatory standards as well as the approach used in determining capital requirements for other US financial institution, e.g., banks. To date, US moves have been too limited and tentative, such as the effort to adopt a principles-based approach to determining reserve requirements for life insurers. To make it more palatable to insurers, a true paradigm shift should be accompanied by the elimination or easing of many prescriptive regulatory requirements. If new standards are simply heaped on top of existing rules and requirements, insurers will not perceive a net gain in regulatory efficiency and will be more likely to strongly oppose such a move.

C. Financial Monitoring

The US has a highly-developed monitoring framework that, arguably, is motivated in part by its relatively low capital requirements. However, these systems are static, "ratio-based" tools. They involve no dynamic testing or modeling, which

admittedly is difficult to perform using a standard approach but not impossible.¹⁸ Financial examinations also primarily focus on verifying the accuracy of an insurer's financial statement and its compliance with regulations, although regulators have the authority to examine all aspects of an insurers' management and operations. Targeted examinations can be called to focus on a certain aspect of an insurer's financial condition or operations but such exams are generally triggered by a review of an insurer's financial statement and not other warning signs. Finally, regulators can access a wide range of information to gain insight into an insurer's true financial condition and risk but the evidence does not indicate that this has become a significant component of the solvency monitoring process.

The inadequacies of the US system were revealed by the costly failure of the Reliance group of insurance companies in 2001, which exhibited highly-risky behavior several years before regulators were alerted and took any corrective action. By the time regulators seized the company, it was at least \$2 billion in the red and far beyond rehabilitation. The fact that Reliance was able to dig a \$2 billion hole before it was stopped also demonstrated the inadequacy of US RBC standards. The failure of five Florida insurers (following the 2004-2005 hurricanes) that were allowed to underwrite excessive concentrations of coastal exposures offers another example of the deficiencies in US financial regulation (Klein, 2007).

A more comprehensive and "hands-on" approach to financial monitoring would naturally be melded with a shift towards the use of dynamic financial analysis to determine the adequacy of an insurer's risk management and capital. Of course, in a

¹⁸ Cummins, Grace and Phillips (1999) demonstrate how this can be done.

prudential system, the quality of oversight is only as good as the regulators who perform it. This could prove to be a greater challenge with a state-based framework.¹⁹

D. Reinsurance

Another problem lies with the US approach towards foreign reinsurers. In order for a US insurer to claim “accounting credit” for reinsurance recoverables, their reinsurers must be licensed in the US or post collateral equal to their obligations to US insurers. This increases the cost of reinsurance for US insurers and creates a disincentive to purchase optimal amounts of reinsurance. It also places US insurers at a competitive disadvantage relative to non-US insurers. In contrast, the EU’s Solvency II initiative would eliminate collateral requirements for foreign reinsurers.

The NAIC has been working on a modified approach that would scale a foreign reinsurers’ collateral obligation according to a rating of its financial strength. Cummins (2007) argues that this is a second-best solution that would be unnecessarily cumbersome and advocates the removal of all collateral requirements. Even as a second-best solution, the NAIC proposal has been fiercely opposed by US reinsurers and any reform of the current approach to foreign reinsurers is likely to be protracted and greatly compromised. An alternative approach would be to eliminate collateral requirements for reinsurers that are domiciled in jurisdictions with adequate regulatory systems.

¹⁹ In the early 1990s, the states and the NAIC adopted an accreditation program to certify the adequacy of each state’s financial regulation. While there is evidence that the program helped to improve states’ financial regulation, evaluating a state’s performance in applying a prudential regulatory approach could prove to be a more daunting task.

E. Intervention and Managing Insolvencies

Another aspect of US solvency regulation that deserves mention is its system for intervention against financially distressed insurers and managing their insolvencies (termed “receiverships”). Grace, Klein and Phillips (2002a) identify a number of problems with the US receivership system and also find evidence of regulators exercising excessive forbearance in dealing with troubled insurers. Under the current system, each state manages the receiverships of its domiciliary insurers that become insolvent. Receivership management is highly inefficient and largely opaque to anyone other than the receivers. Grace, Klein and Phillips (2002a) estimated the average cost of property-casualty insurer insolvencies (over the period 1986-1999) to be \$1.10 per \$1 of pre-insolvency assets which is considerably higher than the estimated costs of bank insolvencies.²⁰ They found evidence of three major factors contributing to higher insurer insolvency costs: 1) the financial condition of an insurer prior to insolvency and the moral hazard incentives of its managers; 2) regulatory forbearance; and 3) regulatory management of insurer receiverships. The moral hazard that can arise from insolvency guarantees increases the importance effective regulatory oversight.

After the issuance of the Grace, Klein and Phillips (2002a) report and other critiques, the NAIC embarked on a tortuous process to reform some aspects of the system. Unfortunately, this effort has been bogged down by a fierce battle between groups with strong vested interests in the current system and other stakeholders who advocate significant reforms. It is unclear when and how this battle will be resolved, but the outcome is likely to fall short of what many external experts and stakeholders believe

²⁰ Hall (2000) estimated this cost to be \$1.22 for each \$1 of pre-insolvency assets using a shorter time period 1986-1994. These costs are substantially higher than those for U.S. bank insolvencies with estimates ranging between \$0.20 and \$0.30 per \$1 of pre-insolvency assets (James, 1991; Kaufmann, 2001).

is needed. We should note that the proposed OFC legislation retains reliance on state guaranty associations, subject to federal standards.²¹

F. Moving Towards a Better System

There is a strong need to upgrade US solvency regulation to what experts would consider to be “best practices.” The EU’s Solvency II could be used as a template but US regulators need not mimic any particular system to create the best possible system. It is fairly clear that the US needs to move to a more comprehensive approach to financial regulation that employs some form of dynamic modeling and relies on more than financial statements (and other standard reports) to assess insurers’ risk. Dynamic modeling is best performed by each insurer using an internal model subject to regulatory review. This is a reasonable requirement for larger insurers but may be problematic for smaller insurers as the EU has found. Smaller insurers could be required to use a standard dynamic model (the EU is developing such a model) which will be less informative than a customized, internal model but better than the current static solvency testing employed by US regulators.

US regulators have talked about employing a principles-based approach to solvency oversight but the current system falls far short of this vision. Admittedly, this will be a huge task and challenge as it would involve discarding the exhaustive set of rules currently in place with a set of principles and standards that regulators would need to understand, apply and enforce. This would be a “sea-change” in the current regulatory

²¹ The main reason for this is the concern a separate guaranty system for federally-regulated insurers would substantially diminish the financial capacity of state guaranty associations. However, when the authority for solvency oversight and the management of insolvency guarantees are not integrated, issues and problems can arise.

paradigm and may not occur within the foreseeable future without a regime change or substantial economic pressure.

We should note that the industry has not been pushing for a major overhaul of the US financial regulatory system, although it has advocated some specific reforms as discussed above. Some (possibly many) US insurers might view an EU-type of system as superior, but they are likely skeptical that US regulators would substitute its extensive set of rules and reporting requirements with a more efficient and effective system. Ultimately, international pressures may be the primary catalyst for substantive reform of the US system. A federal regulator might embrace a new paradigm and a regime change would present an opportunity for significant reforms, but there is no guaranty that this would occur.

IV. Market Regulation

A. Price Regulation

The industry push for policy reforms is aimed primarily at market regulation. The most prominent and criticized policy is rate regulation. The extent and stringency of rate regulation varies significantly by line and by state. The lines subject to the greatest rate regulation are personal auto, homeowners, and workers' compensation insurance. Table IV.1 summarizes the type of rate regulatory system employed by each state for these principal lines. It should be noted that even states with so-called "competitive rating" systems may still seek to impose binding price constraints.

The reality is that in most states and markets, at a given point in time, regulators do not attempt to impose severe price constraints. The problem arises when strong cost pressures compel insurers to raise their prices and regulators resist market forces in an ill-

fated attempt to ease the impact on consumers.²² Inevitably, severe market distortions occur. Ultimately, insurance markets can be sucked into a “downward spiral” as the supply of private insurance evaporates and state mechanisms are forced to cover the gap. Rate suppression also can decrease incentives to reduce risk which can lead to rising claim costs which further increases pricing and market pressures. Together, these developments can create major crises in the cost and supply of insurance. Florida’s property insurance crisis offers the most current example of regulation gone awry (Klein, 2007).

The argument for rate deregulation is fairly straight-forward. One would expect that prices in competitive insurance markets would be “actuarially-fair” and not excessive. Also, competition should drive insurers to be efficient and prices should gravitate to the lowest possible level. If insurers will charge competitive prices in the absence of government intervention, then the need for regulation evaporates. The empirical research overwhelmingly confirms both the competitive nature of insurance markets and the lack of benefits from rate regulation as we discussed in Section II.²³ Requiring or authorizing regulators to regulate rates invites political pressure and interference that can lead to the dismal scenario described above. Several states have recently deregulated auto insurance rates (e.g., Georgia and Massachusetts) but deregulation needs to be extended to all states for all lines of insurance.²⁴ Unfortunately, some states with competitive rating systems (e.g., Florida) have moved back to non-

²² Regulators may seek to suppress overall rate levels and/or compress rate differentials between low and high-risk insureds.

²³ For analyses of competition in insurance markets see Klein (2005), Cummins and Weiss (1991) and Grace and Klein (2007).

²⁴ See Cummins (2002) for a collection of case studies of good and bad regulatory policies in selected states. Derrig and Tennyson (2008) provide a more current assessment of auto insurance regulation in Massachusetts.

competitive rating systems. Hence, “re-regulation” remains a constant threat that warrants vigilance and informed discourse.

B. Residual Market Mechanisms

A more obscure aspect of insurance, except when major problems develop, is the management of residual market mechanisms (RMMs). These mechanisms take on different forms but their stated intention is to provide a source of insurance coverage for buyers who cannot obtain coverage from an insurer in what is called the “voluntary market.” They are commonly found in personal auto insurance and workers’ compensation and in the majority of states for homeowners insurance. It could be argued that these mechanisms serve a legitimate purpose and may be unavoidable in the presence of compulsory insurance requirements. Further, these mechanisms generally remain small in states where insurers are allowed to charge risk-based prices and they are managed to be truly “markets of last resort” with adequate rates and stringent eligibility requirements.

However, significant problems can arise when the voluntary market is subject to severe regulatory constraints and residual market mechanisms are mismanaged. When this happens, RMMs can grow rapidly and incur substantial deficits that are assessed back to voluntary market insureds. This can lead to the infamous downward spiral (described above) in which the voluntary market begins to implode as the RMM explodes. Figure IV.1-IV.2 documents the rapid growth that has occurred in selected residual markets as the result of bad regulatory policies. It also shows how these auto insurance RMMs shrank in some states as regulatory conditions improved, e.g., South

Carolina.²⁵ Florida offers another example of bad regulation and residual market administration – its residual market for property insurance now accounts for 25 percent of that market. Hence, good rate regulatory policies – preferably price deregulation – should be accompanied by the proper design and administration of residual market mechanisms. This requires that RMMs charge risk-based rates, enforce strict eligibility requirements, and avoid funding shortfalls.

C. Product Regulation

A third aspect of market regulation that receives considerable scrutiny is the area of policy forms and insurer's products. In a competitive market, we would expect most insurers to develop and offer legitimate insurance products that would serve consumers' needs and preferences according to the kinds and extent of coverage they are willing to pay for. At the same time, because of consumers' difficulty in understanding insurance policy provisions, some insurers might seek to exploit consumer ignorance by selling them products that contain substantial coverage gaps or unfavorable terms that are not transparent. This problem should be largely confined to individual consumers and possibly small business owners but would not be expected to extend to larger, more sophisticated commercial buyers.

Hence, reforming product regulation is a more complicated proposition than deregulating prices. There are two elements of product regulation that require particular attention. The first is mandated coverages or prohibitions on the exclusions that may be offered in a policy (Harrington, 2006). The second aspect is the arduous review process

²⁵ Grace, Klein and Phillips (2002b) analyzed the turn-around in South Carolina when it reformed its regulation of auto insurance.

that insurers must undergo to get products approved and introduced in the market. While the industry might support broad deregulation of insurance products, regulatory experts might understandably differ on how far such deregulation should go.

State-mandated coverages and benefits are a significant problem, especially in health insurance. State health insurance mandates vary greatly and cover a broad range (see NAIC, 2008). They can include mandated benefits or covered services for things such as cancer screening, infertility treatments, mental illness and substance abuse. While mandating such benefits may seem well intended, they can significantly increase the cost of health insurance and potentially limit its availability for all consumers. It would be preferable to allow employers/employees and other consumers to choose the benefits they are willing to pay for.

The lengthy and sometimes tortuous review and approval of insurance products can create significant inefficiencies and hamper market competition. The concern does not lie with ensuring that certain kinds of policies (e.g., homeowners insurance) provide standard coverages and that coverage terms and exclusions are relatively transparent. The biggest problem lies with life insurance and annuity products where variation and innovation are integral to market competition and efficiency. As indicated in Table IV.2, most states subject life insurance policy forms to prior approval and only 33 states participate in an interstate commission intended to ease the filing and approval process. The high costs and delays in introducing new life insurance products are substantial competitive impediments in life insurance.

In our opinion, some degree of regulatory oversight of personal insurance products is warranted. However, the regulatory requirements for personal insurance

products should be rationalized and standardized. Mandated coverages or benefits need to be greatly curtailed. Further, the review process should be greatly streamlined and expedited. Finally, insurance products purchased by commercial insurance buyers should be deregulated. These kinds of reforms may be the most difficult to achieve under the current system of state regulation.

D. Underwriting and Other Market Practices

Another complex area is the scope of activities encompassed within the underwriting function. These include risk assessment, risk classification, accepting or rejecting insurance applications, non-renewal or cancellation of existing policies, determining the premium that will be charged (for a specific insured), product assignment and special terms and conditions attached to issuing a policy. Regulatory rules and interference with underwriting activities varies by state and line. For the most part, regulators generally give insurers fairly wide discretion in underwriting risks but there are some notable exceptions that warrant attention. They include: 1) mandatory offer requirements; 2) restrictions on the use of certain factors in underwriting and pricing; and 3) interference with an insurer's efforts to restructure its portfolio of exposures.

Some states impose mandatory offer requirements, also called "take-all-comers" laws, which compel insurers to accept any applicant as long as they meet minimal insurability requirements. These requirements are often imposed in auto and home insurance which are viewed as "essential" insurance coverages that justify such requirements. These requirements undermine an insurer's efforts to achieve a balanced portfolio of risks and avoid adverse selection. They are especially problematic when

regulators constrain insurers' rate structures and the coupling of a mandatory offer requirement and price regulation is not a sheer coincidence.

A related problem is created by prohibitions of or limitations on the underwriting and pricing factors used by insurers. Clearly, there are some characteristics such as race that go beyond the pale of what is appropriate. The problem lies with constraining insurers' use of factors that are statistically correlated with the risk of loss and do not violate societal taboos. One example is the use of credit scores in auto and home insurance. There is considerable statistical evidence that credit scores are strongly correlated with risk but their use has been highly controversial (Brockett and Golden, 2007). Critics contend that there is not a causal link between a person's credit score and their risk of filing a claim and credit scores give false indications for some insureds. Correspondingly, an increasing number of states are limiting the use of credit scoring in underwriting and pricing.

However, one could make similar observations about many of the underwriting and pricing factors that insurers use in auto and home insurance. The fundamental issue is whether insurers should be allowed to use factors that improve the overall accuracy of their underwriting and pricing or whether they should be allowed to only use factors that are unlikely to give an incorrect indication of a given insured's risk level. Risk classification is inherently imperfect and competition should drive insurers to use the best factors because their failure to do so will expose them to adverse selection and "cherry-picking" by their competitors. This issue is also likely to be contentious in any effort to reform regulatory policies and it would be desirable to develop a set of principles that would guide regulation in this area.

There is also the problem of regulatory attempts to prevent or hamper insurers in restructuring their portfolios of exposures. The best and most current example of this policy is Florida's attempt to constrain insurers' retrenchment from high-risk coastal areas. Florida officials are seeking to preserve the availability of insurance but retrenching insurers perceive the need to reduce what they consider to be excessive concentrations of high-risk exposures that greatly increase their financial vulnerability to hurricane losses and are unsustainable from a business perspective. Ultimately, these kinds of government constraints are doomed to fail and impede the readjustment of insurance markets to new, sustainable equilibriums. As insurers with excessive concentrations of coastal exposures retrench, this creates opportunities for other insurers that are well-positioned to fill the gap if they are allowed to charge adequate rates and take other prudent steps to manage their financial risk (Grace, Klein, and Liu, 2006). This may be a difficult pill to swallow for politicians but it is the only viable solution without a federal bailout, e.g., a federal catastrophe insurance/reinsurance program. It appears that coastal politicians are counting heavily on such a bailout but they may be disappointed.

Additionally, the general system for regulating insurers' market conduct needs to be dramatically revamped. Currently, the states subject insurers to extensive, duplicative and costly examinations that focus too much on minor errors and too little on major patterns of abuse. In other words, regulators "miss the forest for the trees." Regulators also fail to recognize and encourage insurer self-compliance efforts. Klein and Schacht (2001) outline a more effective and efficient approach to market conduct monitoring that would maximize reliance on self-regulatory mechanisms and target regulatory investigation and enforcement to significant problems.

V. Insurance and Antitrust Policy

The McCarran-Ferguson Act²⁶ (MFA) was passed in 1945 following the Supreme Court's 1944 decision in *Southeastern Underwriters*.²⁷ In that case, the Court held that insurance, which had been thought to be immune from federal regulation, was subject to antitrust and, possibly, other federal laws. The MFA provided a Commerce Clause exemption to the insurance industry to allow it to operate under the regulatory authority of the states and not the federal antitrust laws. Hence, insurers were given a limited antitrust exemption that was coordinated with compensating regulation by the states. The principal objective of the exemption was to allow insurers to use uniform price structures developed by industry rating organizations and approved by state regulators.

In considering industry antitrust law, it is helpful to look at some simple statistics describing how the insurance industry of 1945 compares to that of 2006. The industry has changed significantly which has implications for the modification and application of antitrust laws. Table V.1 shows premium volume for companies in 1945 in 2006 dollars. There has been a twenty five-fold increase in property-casualty insurance premiums and a 10-fold increase in life and annuity premiums. In contrast, the US population has just more than doubled over the same time period and automobiles per capita have increased about 2.5 times. The number of property-liability companies has increased about 4.5 times and the number of life insurers has increased about 3.5 times.²⁸ Life industry assets have increased about 10-fold while the assets held by the property-liability industry have

²⁶ 15 U.S.C. §§ 1011-1015.

²⁷ 322 U.S. 533 (1944).

²⁸ Many of the property-liability companies are captive insurers which means they were set up to cover the property or liability risks of general corporations. They do not operate to sell to the general public.

increased over 130 times. Overall, the sale of life and non-life insurance products and their “coverage” of US households and firms have greatly increased, along with the amount of assets managed by the insurance industry.

Table VI.2 shows the further extension of insurance transactions across state borders. Insurance is now predominately a large multistate industry with a high percentage of premiums written by companies operating in over one-third of the states. Table V.2 shows the premium volume for the nationally-significant companies (i.e., those with licenses in 17 or more states).²⁹ For the life business, almost all premiums and annuity considerations come from nationally-significant companies. For the property-liability industry, approximately 80 percent of its premiums are written by nationally-significant companies.

The industry has grown dramatically in a number of dimensions since the 1940s and has many more ties to the national and international insurance markets. Insurance rating or advisory organizations no longer issue uniform rate structures which insurers are required to follow. In fact, it is possible that the entire rationale for the industry’s antitrust exemption provided by the MFA no longer exists. Insurers have a much better understanding of how to price insurance products and markets are more competitive and dynamic. In fact, other than the fact that repeal of the MFA will create legal uncertainty about industry practices, there do not seem to be many reasons to object to repeal.

²⁹ This designation of “nationally significant companies” is based on criteria used by the NAIC for solvency monitoring purposes.

A. Interpretation of the MFA Exemption

The MFA does three things to address the perceived consequences of the Supreme Court's ruling in the *Southeastern Underwriters* case. First, under the MFA the federal antitrust laws do not apply to the "business of insurance" as long as the states regulate insurance. This means that if a state regulates the industry, then the antitrust laws cannot be used against the industry. What is interesting about this portion of the Act is that the meanings of the terms "business of insurance" and the "regulation" was left to legal interpretation through litigation.

The presumption underlying the MFA is that the federal government would rely on the states to regulate and tax insurance companies, but if they failed to do so, then the antitrust laws would apply. However, there were a number of cases that tested the scope of the business of insurance exemption. For example, in a relatively recent case - *Union Labor Life Ins. Co. v. Pireno*³⁰ - the Court used three criteria relevant to determine whether an insurer's conduct is consistent with the business of insurance exemption: "[F]irst, whether the practice has the effect of transferring or spreading a policyholder's risk; second, whether the practice is an integral part of the policy relationship between the insurer and the insured; and third, whether the practice is limited to entities within the insurance industry."³¹ While not definitive, the GAO (2005) undertook a review of the litigation regarding the business of insurance definition. It concluded that:

Courts tend to find that activities among insurers involving cooperative ratemaking and related functions constitute the business of insurance. Insurers may enter into agreements or arrangements that do not involve such matters, but the more the arrangements involve functions that are not unique to the insurance business, or whose primary impact is not on the

³⁰ 458 U.S. 119 (1982)

³¹ *id.* at 129.

insurance market, the less likely courts are to apply the exemption (GAO (2005) at 4).

This is a narrow reading of the term “business of insurance” than others that have been offered. For example, agreements between insurers and pharmacies are not within the business of insurance although the insurer is arguably making the agreements in order to provide lower premiums prices.³² This is because the pharmacies are not insurers.

Second, the GAO concluded that:

Courts tend to find that activities between insurers and agents involving the terms of their contracts or the termination of their relationships constitute the business of insurance, provided that the activities are closely linked to the insurer/insured relationship and involve the agent’s insurance dealings (GAO (2005) at 5).

This implies that agreements between insurers and their agents are the business of insurance, but if there was an agent who sold insurance and an insurer’s non-insurance services (i.e. banking securities), any dispute about these other services would not be the business of insurance.

Third, the GAO found that:

Courts tend to find that activities involving the relationship between insurer and insured constitute the business of insurance. If the activity does not involve risk-spreading, however, or if its primary impact on competition is not in the insurance industry, courts are less likely to apply the exemption (GAO (2005) at 5).

Thus, insurers could require certain ties between products. The classic example is that one must be a member of AARP to obtain AARP-related insurance products produced by a third party insurer. However, if an insurer tried to tie insurance to the

³² The court in other cases said that the business of insurance exemption is not an exemption for the business of insurance companies, but a more narrow activity focus. See, for example., *Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205 (1979).

purchase of a car, it might be outside the business of insurance exemption. Thus, the GAO concluded that the business of insurance, consistent with most antitrust exemptions, should be interpreted narrowly.

Most of the modern discussion of the antitrust exemption concerns insurers' ability to share data and allow "advisory organizations" to analyze these data to develop and file "indicated loss costs" for certain lines of insurance.³³ The data shared are loss-related and are provided to insurers to assist them in developing accurate rates.³⁴ Pooled industry data can be more reliable and actuarially credible than individual company data, especially for smaller insurers. The larger the volume of business an insurer writes, the more it can rely on its own data for pricing. Medium-sized insurers may use a combination of both their own and industry data and the largest insurers may rely solely on their own data. Ultimately, the compilation and dissemination of industry loss data can facilitate competition and more efficient markets. Information is the most important resource in the insurance industry and data pooling reduces entry barriers and offers other operational efficiencies³⁵.

This type of data sharing has been facilitated by private entities known collectively as advisory or statistical agents. Statistical agents only collect and disseminate data and generally perform minimal processing and analysis of the data they

³³ Almost universally, any discussion of the repeal of the MFA includes a safe harbor provision for the sharing of data. See e.g. ABA, Section on Antitrust Law, *Comments to the Antitrust Modernization Commission*, found at <http://www.abanet.org/antitrust/at-comments/2006/04-06/Com-AMC-McCarranFerguson.pdf>. "Indicated loss costs" refer to the expected losses (i.e., claims costs) for certain lines of business in each state. This information is provided in manuals or circulars which include factors that can be used to calculate the expected loss cost for a given exposure according to its characteristics.

³⁴ The most sophisticated and useful compilations include premium, loss and exposure information organized by various rating characteristics that are essential to determining the expected loss cost for a given exposure (e.g., a house or auto insured for one year). For example, in homeowners insurance, these rating characteristics would include the location of a home and its type of construction, among many others.

³⁵ Coincidentally, regulators also access and use this information in performing their functions. Hence, it has been more often the case that regulators and not insurers have advocated more extensive data reporting.

collect. Advisory organizations not only collect data but also perform more extensive analysis and develop indicated loss costs. The two largest advisory organizations are the Insurance Services Office (ISO) and the National Council on Compensation Insurance (NCCI). ISO collects member premium, exposure and loss data, aggregates this information, and provides indicated loss costs for various property-casualty insurance lines. The NCCI undertakes the same type of activities for workers' compensation insurance. Both organizations file indicated loss costs with regulators in most states that do not include provisions for expenses and profits. When these filings are approved by regulators, individual insurers may use these loss costs, with or without modification, in filing their specific rates that will include provisions for expenses and profits.³⁶

The second question the MFA addresses is the level of regulation which would prohibit the enforcement of the antitrust acts against the insurance industry. One could properly make the argument that if a state had no regulation, then the antitrust laws would apply to the insurance industry's practices within the state. However, what if a state had regulation, but it was not adequate?

The courts do not inquire about the adequacy of state regulation directly. Essentially they have held that if an activity is regulated by state law then the insurer is subject to general regulatory standards. Further, the quality of the regulatory

³⁶ In the early 1990s, ISO voluntarily decided to no longer provide advisory rates to its subscribers. Instead it provides indicated loss costs, that do not include expense and profit provision, which a subscriber could then use in developing its own rates. The ISO undertook this change as to avoid falling outside the limited antitrust exemption under the MFA. The US Department of Justice summarized its understanding of what ISO purported to do and decided it would offer no challenges to its activities, but reserved the right to do so in the future if circumstances warranted. See Letter dated January 25, 1994 from Assistant US. Attorney General, Anne Bingaman to Mr. Joel Cohen acting on behalf of ISO. Found at <http://www.usdoj.gov/atr/public/busreview/211724.htm>. The NCCI came to a similar decision shortly thereafter.

apparatus or how regulations are enforced is not part of the calculus as to whether an exception is granted.³⁷

Finally, the third part of the Act states that federal anti-trust laws apply deals with cases of boycott, coercion, and intimidation. In *Hartford Fire Insurance Company v. California* the issue of boycott was examined by the Supreme Court.³⁸ In this case a number of state attorneys general and private parties complained that ISO and a set of insurers conspired to change a standard insurance contract form. In addition, it was alleged that reinsurance companies participated in the conspiracy by saying that they would not supply reinsurance to any company unless the company used the new contract. Hence, a boycott was alleged to effectuate the use of the new contract.³⁹ While the court did not reach the issue of whether a boycott occurred in this case it provided guidance for such a determination. In fact, a boycott must be more than a refusal to deal. This would preclude a company from taking high-risk customers, for example. A boycott must include a refusal to deal based on other unrelated transactions. For example, if insurers also refused to sell insurance for other forms of coverage, a boycott might exist.

³⁷ There appears to be little discussion of this question. See e.g. *AFL-CIO v. Insurance Rating Board*, 451 F.2d 1178 (6th Cir. 1971), cert. denied, 409 U.S. 917 (1972). The court held that a state regulates the business of insurance within the meaning of the MFA when a state statute allows or prohibits certain conduct on the part of the insurance companies.

³⁸ 509 U.S. 764 (1993).

³⁹ Prior to 1980 or so the ISO had an “occurrence form” for certain liability policies. This meant that an insurer was liable for coverage if a loss occurred. The industry expected that this term would mean that the loss occurred during the time when the insured was covered by the contract. However, in a set of court cases the courts interpreted the coverage more broadly holding insurers who provided coverage in say 1980 (and not previously) with covering a loss which occurred in say 1970. ISO changed the standard form to a “claims-made form”. Under this form, an insurer was only liable for claims that were filed during the contract period, no matter when the loss giving rise to the claim occurred. Insurers would then underwrite based on expected claims that might occur to present conditions as well as past conditions. Allegedly, the ISO did not develop forms acceptable to the industry and the industry was able to recruit reinsurers who would agree to not accept reinsurance unless the form was changed to provide more protections for the insurers.

In sum, the antitrust exemption has been interpreted narrowly. One of the main arguments regarding the MFA was to allow smaller companies to share data because they would not have the actuarial staff or sufficient numbers of customers to set accurate prices using internal data. In fact, in most proposals involving repeal of the MFA this is the exemption that still remains.

B. Arguments for Repeal of the MFA

One of the basic arguments mentioned in *Southeastern Underwriters* was the fact that the insurance industry would be destroyed by competition and thus the state regulation of the business was needed to supplant the antitrust laws. Competition allegedly causes price decreases and insurers would have an incentive to lower prices so much that their solvency would be endangered. The whole rationale for rating bureaus like Southeastern Underwriters was to prevent this type of destructive price competition. This argument, which may have been valid in the past, is no longer viable today. Our understanding of competition and insurance pricing is much different than it was in the beginning of the twentieth century.⁴⁰ Actuaries can now price insurance products more accurately and the states have strengthened their financial standards and monitoring tools, which while imperfect, are better than the systems available to earlier insurance regulators.

While it is true that one of the major reasons insurers fail has to do with improper pricing and inadequate reserves, there is not an apparent link between the competitive market environment and failure (AM Best, 2002). If anything, competition puts poor

⁴⁰ A cursory reading of law review commentary of the time suggests that legal researchers never questioned the need for regulation as the market was not competent to provide the proper outcome. See, for example, Note, (1951), Kimball and Boyce (1952) and for a more recent example, see Zagalis (1994).

managers to pasture, but it does not cause a large number of insurers to fail as it appeared to do in the 1800s. It is true that some commercial lines markets are subject to cycles in the supply and price of insurance which can result in prices falling below insurers' costs. However, this is not the kind of phenomenon that warrants a return to uniform pricing subject to regulatory oversight. Most insurers survive "soft markets" with low or negative profits but their adverse performance does not threaten their solvency. A better regulatory approach for the small number of insurers that engage in excessively hazardous practices would be regulatory interventions against these insurers to correct this behavior. This approach, of course, would be most effective if US regulators improved their financial regulatory philosophy and methods as we discussed in Section III. Further, we have seen numerous examples of how competition has worked well to serve the interests of consumers and insurers, as we discussed above.

One of the rationales consumer advocates employ when they argue for repeal is that all the industry's collusive behavior will vanish. However, since concentration measures and entry barriers in most markets are relatively low, it is difficult to see how the industry will be affected by repealing a rule which prevents collusion when the structure of insurance markets precludes collusion. During the last twenty years there have been a number of academic studies that demonstrate and conclude that insurance markets are highly competitive, as we have noted.

In addition, while there is a general antitrust exemption of the insurance industry, it is narrow and many states have antitrust laws or consumer protection laws which apply to the insurance industry.⁴¹ It is important to note that major states such as California,

⁴¹ Hawk and Laudati (1996) claim that all 50 states have either a statute or a state constitutional provision regarding antitrust.

New York, and Florida have consumer protection or antitrust laws which apply to insurer behavior within the state. Even if these were the only states with such laws, repealing the antitrust law exemption would likely have little or no effect on major portions of the industry as they are participating in these three states.

The MFA is often employed as a cudgel by consumer advocates who insist that many problems in the insurance industry would be resolved if there was no antitrust exemption (see, for example, Angoff, 1986 and 1988 and Doroshov and Gottlieb, 2002).⁴² The consumer advocates' list of remedies is not confined to the repeal of the MFA. Their position is that any repeal would be part of a systematic and significant increase in state regulation. However, as we discussed earlier, empirical studies of insurance rate regulation have concluded that it provides negligible if any benefits but sometimes can cause significant problems if regulators attempt to suppress prices substantially below costs.

Other consumer advocates have a different list. For example, J. Robert Hunter, a well known advocate of repealing the MFA exemption, lists a number of reasons why the exemption should be repealed:

- Anticompetitive behavior by the insurance industry has been a prime cause of the homeowners insurance crisis along America's coastlines.
- State attorneys general have had to intercede to stop anticompetitive acts in the industry, including bid-rigging, market allocation arrangements and hidden kickbacks to brokers. This development has also demonstrated that state insurance regulation again has failed to police collusive behavior and that even the most sophisticated buyers are not able to protect themselves from such acts.

⁴² Other items on the list of reforms include requiring more disclosure, allowing more competition with banks, allow joint underwriting arrangements, establish more state reinsurers and state run insurance companies, toughen enforcement, prohibit the revolving door between regulators and insurers, and establish independent consumer advocates. See Angoff (1986).

- Under threat of federal intervention, the insurance industry has been pushing states to deregulate insurance. This is an approach that makes no sense when collusion and cartel behavior is allowed.⁴³

The three points are often used as condemnations of the industry. However, the presence of the antitrust laws may have no influence on these concerns.

The allegation that insurers are using an antitrust preemption to refuse to sell to customers is an old critique. It was used in the 1980s to suggest that the industry was raising prices or causing shortages in order to extract collusive profits (Angoff, 1986). However, Harrington and Litan (1988) provide evidence that the liability crisis was due to the growth in losses. Current problems in homeowners insurance markets in coastal states subject to high hurricane risk have a similar explanation. Loss shocks and higher risk estimates have caused the supply of insurance to tighten but these markets will tend to move to new sustainable equilibriums if regulators allow them to do so (Grace and Klein, 2008b).

Insurers' adjustment of their prices and exposures in these markets are actions consistent with the prudent management. Firms which separately decide to follow a certain strategy by merely refusing to write high-risk exposures is not, by itself, engaging in collusion. It is not even a boycott. Under the antitrust laws as applied to the MFA there must be some concerted behavior where coordinated action occurs.⁴⁴ The evidence indicates that insurers are behaving independently and following different strategies in

⁴³ U.S. Senate, Committee on the Judiciary, The McCarran-Ferguson Act: Implications of Repealing The Insurers' Antitrust Exemption, Testimony of J. Robert Hunter, Director of Insurance, Consumer Federation of America.

⁴⁴ *St. Paul Fire and Marine v. Barry*, 438 U.S. 531 (1978) where St. Paul asked its competitors to refuse to sell medical malpractice insurance to its customers in order to get its customers to take a new contract form. This was found to be a concerted action outside of the normal scope of the business of insurance to affect a boycott.

adjusting their prices and exposures according to their specific circumstances (Grace, Klein and Liu, 2006).

If there was concerted action to refuse to write policies in high risk areas, this action could violate the MFA's boycott provision thus bringing this same lawsuit into federal courts. Rather, what we see in states like Florida is a significant restructuring of the homeowners insurance market. The largest insurers have lost market share, some mid-tier writers have essentially maintained their portions of the market, and other insurers have increased their market shares. This picture is antithetical to what we would expect to see in a market where firms were orchestrating their actions to inflate profits.

State attorneys general have successfully sued various segments of the insurance industry even with an antitrust exemption.⁴⁵ At the federal level, lawsuits were entertained regarding the alleged boycott among various insurers, the ISO, and reinsurance regarding the change in the ISO standard liability contract. This is in part due to the boycott exemption in the MFA as well as plethora of state antitrust laws and consumer protection laws.

The final issue raised by Hunter is the "threat" of federal intervention such as that envisioned in the OFC and SMART Act proposals. However, the location or level of regulation has little to do with the presence or absence of antitrust exemptions. Further, the elimination of unnecessary state regulatory constraints and barriers will likely increase the efficiency and competitiveness of insurers. Given that the presence or absence of a federal antitrust law has no real effect on the current insurance industry, one might argue that its repeal should be supported to remove a specious issue that is used to raise unsupported allegations of anticompetitive practices by insurers.

⁴⁵ *Hartford Fire Insurance Company v. California*, 509 U.S. 764 (1993).

C. Arguments for the Status Quo

One of the arguments for the status quo is the ability of companies to share data. The concern is that eliminating the pooling and analysis of loss data would undermine accurate pricing by insurers, particularly smaller companies that are more reliant on industry data. However, if there is a repeal of the MFA, one could readily argue for an exemption for this particular activity. The Sherman Act prohibits contracts, combinations, and conspiracies in restraint of trade. Price fixing has been held to be a *per se* offence, under the Sherman Act § 1's *Rule of Reason* test. However, one could make the case that data sharing is not price fixing and is pro-competitive in effect and thus would be permissible under the law even without the MFA. In fact, in 1977 the Department of Justice undertook a study of insurance regulation (DOJ, 1977). The Department of Justice concluded that certain joint activities including data sharing, product standardization, assessment of community fire standards and the like would be permissible under the Sherman Act as they promote competition and used to reduce the cost of insurance.

Data sharing also has a pro-competitive rationale as it increases the number of firms willing to write business since it reduces the cost of pricing insurance. Because data sharing and other cost-reducing activities are arguably the only kinds of cooperative behavior that might be allowed under the narrow antitrust exemption provided by the MFA, why repeal the exemption? Replacing the law, even with a well-crafted safe harbor provision, will likely lead to uncertainty and raise costs to the firms who would use this data sharing arrangement.

The MFA gives each state the right to choose the style of regulation consistent with the preferences of its voters. Some states might permit more joint behavior than others. Repeal would provide a federal standard for how insurers should behave in every state. However, as mentioned above many, if not all, states have antitrust laws which would prohibit the same type of behavior under state law that the Sherman Act proscribes.⁴⁶ Presumably, this enforcement is the state's prerogative. Further, we do not see many antitrust cases brought at the state level based on state law.⁴⁷ This could be for two reasons; either the industry has not engaged in any anti-competitive behavior under state law or there are no willing plaintiffs. Presumably, the state antitrust or consumer protection law provides a right of a private cause of action so that any aggrieved party with an antitrust injury could present a case to a state court. In addition, most state consumer protection laws provide the state with the right to enforce the law.

D. Concluding Thoughts

The antitrust exemption under the MFA is quite narrow. Permitted activities are those that have a potential beneficial effect on competition. These include data sharing, joint development of products and policy forms, and other joint ventures which expand insurance markets, lower costs and increase competition. These same activities are likely to be viewed as legal without the MFA antitrust exemption. Because the interpretation is narrow and seems to match the types of behavior subject to the *Rule of Reason* test, it is almost immaterial whether the exemption is repealed. At the margin, however, the repeal

⁴⁶ New York's antitrust law for example, dates from 1893, and follows in many respects the Sherman Act. Section 340-347 New York General Business Laws. In particular, Section 340(2) applies specifically to "licensed insurers, licensed insurance agents, licensed insurance brokers, licensed independent adjusters and other persons and organizations subject to the provisions of the insurance law,..."

⁴⁷ New York's action against the brokerage industry is an important exception. However, the rarity of these types of cases proves the point.

of the MFA antitrust exemption would create uncertainty surrounding these arrangements which can only be resolved through litigation. This litigation could be costly and also could have a chilling effect on activities that enhance the efficiency of insurance markets.

VI. Summary and Conclusions

In sum, the economic and political context surrounding proposals for insurance regulatory reforms is complex. The proponents of federal regulation believe they have a strong case and there are a number of arguments that can be made in support of a federal framework. However, the real world is messy and advocates of federal regulation face formidable political opposition that has so far stymied OFC legislation. Both practical considerations and politics will encumber efforts to rationalize insurance regulation. Hence, a major revamping of the current system is unlikely to occur in the near future.

What we are likely to see are “smaller” incremental changes at both the state and federal level which have been the industry’s historical legacy. These changes will not achieve the objectives of reformists, but they may help set the stage for more substantive reforms under more favorable political conditions. Regardless of how the institutional framework for insurance regulation evolves, it is clear that many policies should be reformed to promote market efficiency. This is a prescription that both state and federal regulators should follow as their authorities and roles are considered and possibly changed by the Congress.

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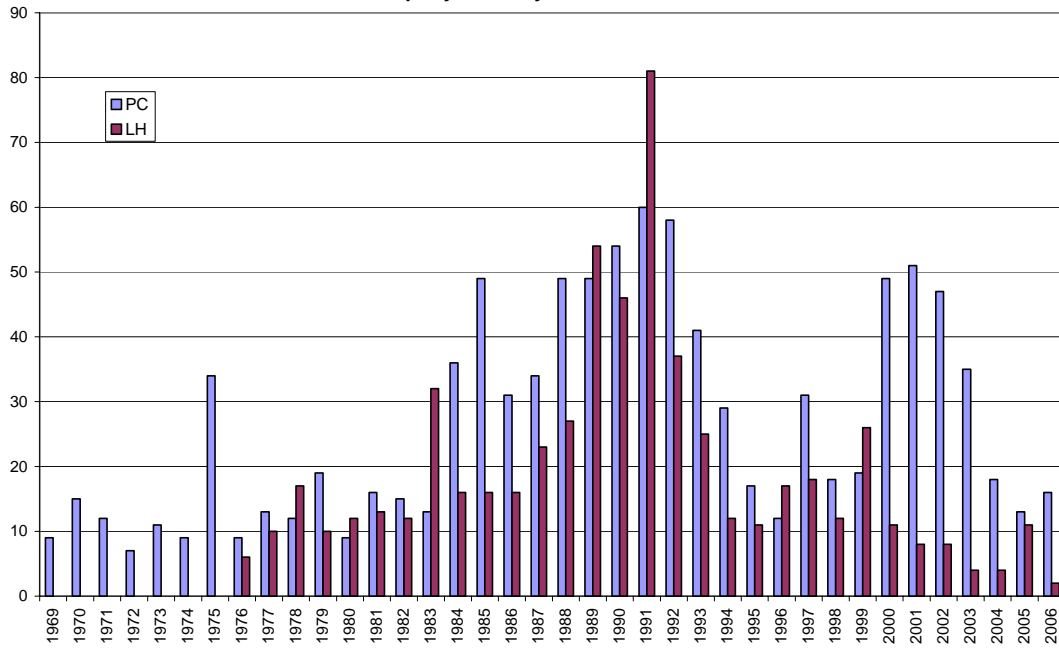
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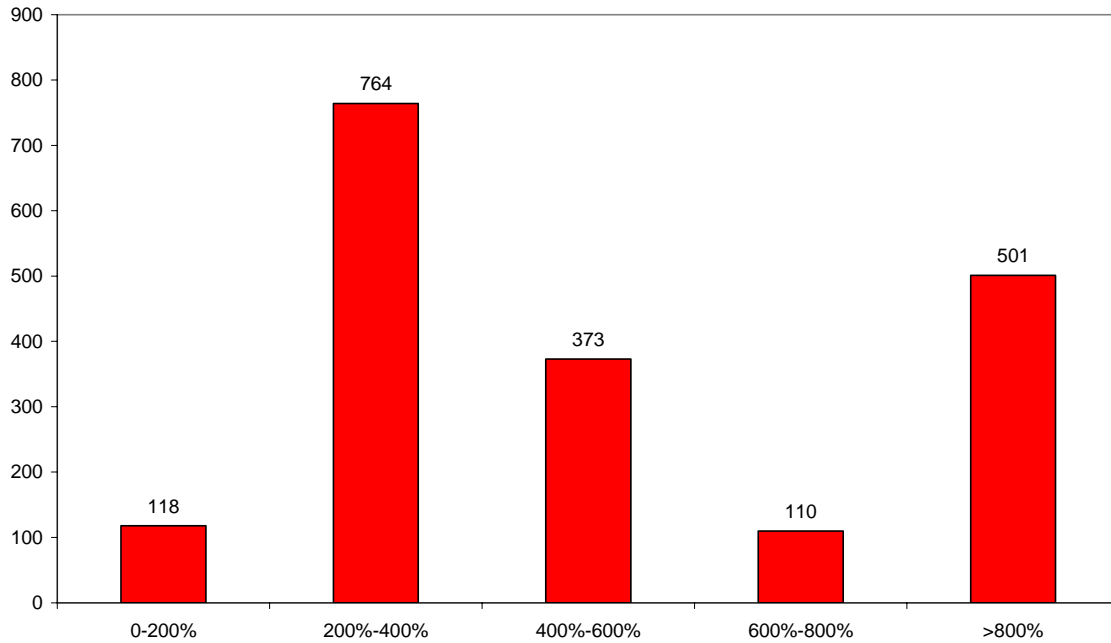
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**Figure III.1
Insurance Company Impairments
Property-Casualty & Life-Health Insurers**



Source: A.M. Best

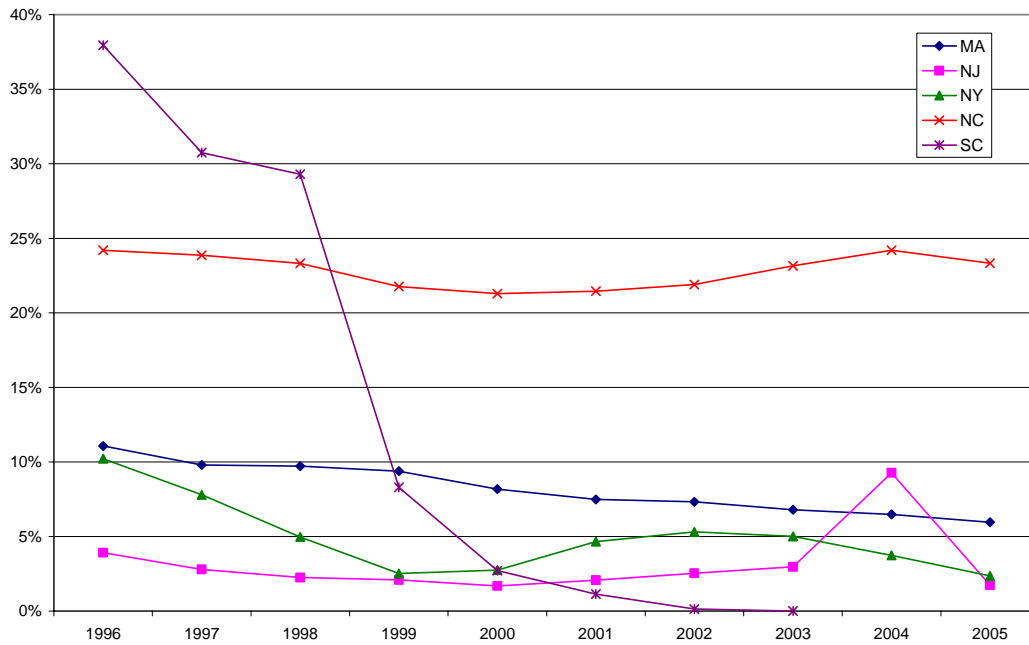
**Figure III.2
Ratio of TAC/RBC to BCAR: Property-Casualty Insurers 2006**



Source: NAIC Financial Data & A.M. Best; Authors' Calculations

| Table IV.1 | | | | | | | |
|--|-----|----|----|---------------------|-----|----|----|
| Summary of State Rate Filing Requirements - Property-Liability | | | | | | | |
| State | PPA | HO | WC | State | PPA | HO | WC |
| Alabama | PA | PA | PA | Montana | FU | FU | FU |
| Alaska | PA | PA | PA | Nebraska | PA | PA | PA |
| Arizona | UF | UF | FU | Nevada | PA | PA | PA |
| Arkansas | FU | FU | PA | New Hampshire | FU | FU | UF |
| California | PA | PA | PA | New Jersey | PA | PA | UF |
| Colorado | FU | FU | FU | New Mexico | PA | PA | PA |
| Connecticut | FU | FU | FU | New York | PA | FU | PA |
| Delaware | FU | FU | FU | North Carolina | PA | PA | FU |
| District of Columbia | FU | FU | PA | North Dakota | PA | PA | PA |
| Florida | FU | FU | PA | Ohio | FU | FU | FU |
| Georgia | FU | FU | FU | Oklahoma | FU | FU | FU |
| Hawaii | PA | PA | PA | Oregon | FU | FU | PA |
| Idaho | UF | UF | PA | Pennsylvania | PA | PA | PA |
| Illinois | UF | UF | UF | Rhode Island | FU | FU | PA |
| Indiana | FU | FU | FU | South Carolina | PA | PA | PA |
| Iowa | UF | UF | PA | South Dakota | PA | PA | PA |
| Kansas | FU | FU | PA | Tennessee | PA | PA | PA |
| Kentucky | FR | FR | FR | Texas | FR | PA | FU |
| Louisiana | FR | FU | FU | Utah | UF | UF | FU |
| Maine | FU | FU | PA | Vermont | UF | UF | FU |
| Maryland | FU | FU | FU | Virginia | FU | FU | PA |
| Massachusetts | FU | FU | FU | Washington | PA | PA | PA |
| Michigan | FU | FU | FU | West Virginia | PA | PA | PA |
| Minnesota | FU | FU | PA | Wisconsin | UF | UF | PA |
| Mississippi | PA | PA | PA | Wyoming | NF | NF | NF |
| Missouri | UF | UF | UF | Source: NAIC | | | |

Figure IV.1
Auto Insurance Residual Market Share
Selected States: 1996-2005



Source: AIPSO

Figure IV.2
Florida Property Residual Market: 1993-2007

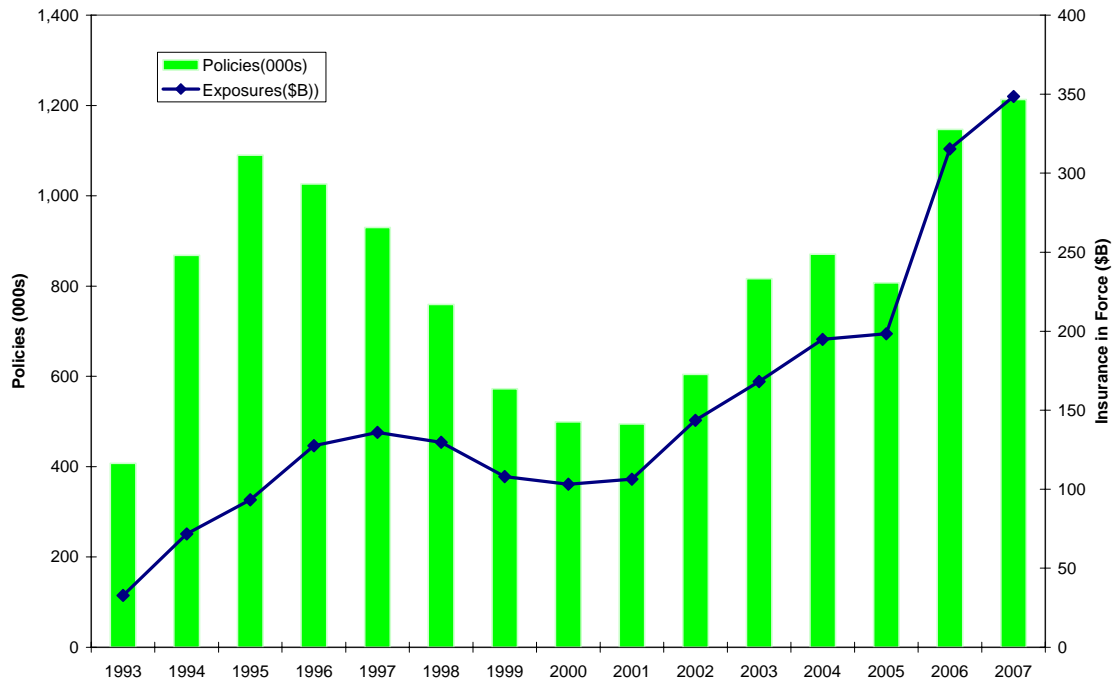


Table IV.2

Summary of State Form Filing Requirements - Life Insurance

| State | Filing Requirement | Interstate Compact Member | State | Filing Requirement | Interstate Compact Member |
|----------------------|--------------------|---------------------------|----------------|--------------------|---------------------------|
| Alabama | No Provision | No | Montana | Prior Approval | No |
| Alaska | Prior Approval | Yes | Nebraska | Prior Approval | Yes |
| Arizona | Prior Approval | No | Nevada | Prior Approval | No |
| Arkansas | Prior Approval | No | New Hampshire | File and Use | Yes |
| California | File and Use | No | New Jersey | Prior Approval | No |
| Colorado | No Provision | Yes | New Mexico | Prior Approval | No |
| Connecticut | Prior Approval | No | New York | Prior Approval | No |
| Delaware | Prior Approval | No | North Carolina | Prior Approval | Yes |
| District of Columbia | File and Use | No | North Dakota | Prior Approval | No |
| Florida | Prior Approval | No | Ohio | Prior Approval | Yes |
| Georgia | Prior Approval | Yes | Oklahoma | Prior Approval | Yes |
| Hawaii | Prior Approval | Yes | Oregon | Prior Approval | No |
| Idaho | File and Use | Yes | Pennsylvania | Prior Approval | Yes |
| Illinois | Prior Approval | No | Puerto Rico | Prior Approval | Yes |
| Indiana | Prior Approval | Yes | Rhode Island | Prior Approval | Yes |
| Iowa | Prior Approval | Yes | South Carolina | Prior Approval | No |
| Kansas | Prior Approval | Yes | South Dakota | Prior Approval | No |
| Kentucky | Prior Approval | Yes | Tennessee | Prior Approval | Yes |
| Louisiana | Prior Approval | No | Texas | File and Use | Yes |
| Maine | Prior Approval | Yes | Utah | File and Use | Yes |
| Maryland | Prior Approval | Yes | Vermont | Prior Approval | Yes |
| Massachusetts | File and Use | Yes | Virginia | Prior Approval | Yes |
| Michigan | Prior Approval | Yes | Washington | Prior Approval | Yes |
| Minnesota | Prior Approval | Yes | West Virginia | Prior Approval | Yes |
| Mississippi | Prior Approval | No | Wisconsin | Prior Approval | Yes |
| Missouri | Prior Approval | No | Wyoming | Prior Approval | Yes |

Source: NAIC

Table V.1 Simple Comparison of U.S Insurance Industries, 1945 and 2006

| Premium Volume | | | Population | Continetal US POP per Sq Mile | Autos* | Autos Per Capita |
|--------------------|--------------------|--------------------|-------------|----------------------------------|-------------|------------------|
| Property-Liability | Life | Life | | | | |
| 1945 | 17,426,483,200 | \$ 58,788,800,000 | 141,183,318 | 44.2 | 25,691,494 | 0.182 |
| 2006 | \$ 443,800,000,000 | \$ 591,903,000,000 | 298,754,819 | 84.6 | 134,012,369 | 0.449 |

| Number of Companies | | | Assets | | Ratio of PC Assets to Life Assets |
|---------------------|------|------|----------------------|----------------------|---|
| Property-Liability | Life | Life | Property-Liability | Life | |
| 1945 | 588 | 348 | \$ 501,726,400,000 | \$ 10,740,520,000 | 2.14% |
| 2006 | 2648 | 1257 | \$ 4,836,215,000,000 | \$ 1,483,013,000,000 | 30.66% |

Sources: Automobiles (incl'dg Taxis), 1945, Public Roads Administration, Highway Statistics, 1945. Does not include AK and HI.

Automobiles, 2006, US Dept of Transportation, Fed. Highway Admin, Highway Statistics 2005,

http://www.fhwa.dot.gov/policy/ohim/hso6/motor_vehicles.htm.

Population (average of 1940 and 1950) annual Census Statistics. <http://www.census.gov/population/censusdata/table-2.pdf>.

Population 2006, US Census Bureau, national and State Population Estimates, <http://www.census.gov/popest/states/NST-ann-est.html>.

Housing units 2006 from US Census Bureau, Housing Estimates, 2006.

Remaining data from the Statistical Abstract of the United States various years.

All dollars in 2006 dollars using U.S. Bureau of Labor Statistics historical series.

Table V.2

Property-Casualty Insurers Grouped by the Number of States in Which They Operate

| | N | Mean | Sum | % of Total Premiums |
|---|-----|------------------|--------------------|------------------------|
| Groups and Companies with 17 or More States of Operation | 242 | \$ 1,771,492,890 | \$ 428,701,279,380 | 81.65% |
| Groups and companies with less than 17 States of Operation | 979 | \$ 98,437,211 | \$ 96,370,029,481 | 18.35% |

Total Premiums for all groups and unaffiliated singles with total nationwide premiums greater than \$100,000. source NAIC Annau Statement files, 2006.