

Insurance Regulation: Principles and Institutions

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Reading Objectives

1. Briefly summarize alternative theories of regulation.
2. Outline the principles of insurance regulation in addressing market failures and protecting consumers.
4. Review the historical origins and development of state insurance regulation.
5. Outline the role and authority of state insurance commissioners.
6. Discuss the resources of state insurance departments.
7. Explain the role of the National Association of Insurance Commissioners in coordinating and serving state insurance regulators.
8. Describe primary policies and activities in the areas of financial and market regulation.
9. Discuss the potential effects of regulation on insurance markets.

Ideally, insurance regulatory institutions and policies should be based on a foundation of principles with respect to the purpose of regulation and the benefits it can provide to consumers and the general public. Economists and legal scholars have developed a set of general principles for government regulation and applied them to various activities and industries (Kahn, 1988; Spulber, 1989). This has not been done in a rigorous and comprehensive way for insurance, but it is possible to apply general regulatory concepts to the specific circumstances of insurance. These principles can help to guide insurance regulators in developing policies that promote market efficiency and fairness and protect consumers.

Of course, the application of regulatory principles to any specific problem requires a healthy respect for the “real world” and not every problem is amenable to “textbook” solutions. Moreover, it must be recognized that insurance regulators function in a bureaucratic and political context that affect their motivations and ability to implement policies that serve the public interest.

I. Regulatory Principles

A. Theories of Regulation

Economists, political scientists and legal scholars have offered various theories to explain regulation and regulatory behavior. Some of these theories are normative in nature, i.e., what regulation should be, and some are positivistic, i.e., how do regulators actually behave. Traditional **public interest theory** analyzes the role of regulation in correcting market failures (defined below) and improving economic performance (Kahn, 1988; Spulber, 1989). This traditional view has been challenged by **economic and political theories of regulation** that examine how economic interests, bureaucracy, political elites and ideology affect regulatory policy (e.g., Stigler, 1971; Peltzman, 1976; Meier, 1985 and 1988). Hence, regulatory policy may not always improve economic efficiency or promote the public interest.

Generally, in evaluating regulation in terms of what would serve the public interest, economists will take a normative approach and apply certain economic principles to determine situations where regulation would be beneficial and the policies that should be employed. However, real-world regulatory policies may be driven by the self interests of government officials and legislators to maximize their political support. When the effects of regulation are opaque to the public, regulators may favor groups with

concentrated economic interests in the adoption of certain policies that will be at the expense of the broader public whose economic interests are more diffuse. In other instances, regulators may play to public biases and preferences on highly visible issues (e.g., the cost of auto and home insurance) even if the resulting policies can have long-term negative effects on consumers. Understanding the political economy of regulation can be helpful in understanding why some policies are adopted that ultimately create market distortions and problems.

B. Regulation Defined

The term "regulation" is often used as if there is a common understanding of its meaning but it can be defined differently. Most analysts use the term narrowly to refer to government constraints on private actions to achieve particular public goals. With respect to insurance, the scope of regulation so defined might encompass such areas as licensing of companies and agents, other entry and exit restrictions, solvency, prices, trade practices, and products. However, the full scope of government involvement with insurance markets is not confined to these areas. Other areas of government action that affect insurance include: public insurance programs; antitrust policy; taxes; public expenditures; property, contract and tort law; and international trade policy, among others. The narrower concept of regulation is the primary frame of reference for this reading, but it is important to note the interrelationship between various areas of public policy that affect insurance. Regulators' efforts to achieve particular market outcomes in insurance can be affected by other government actions.

C. Principles of Insurance Regulation

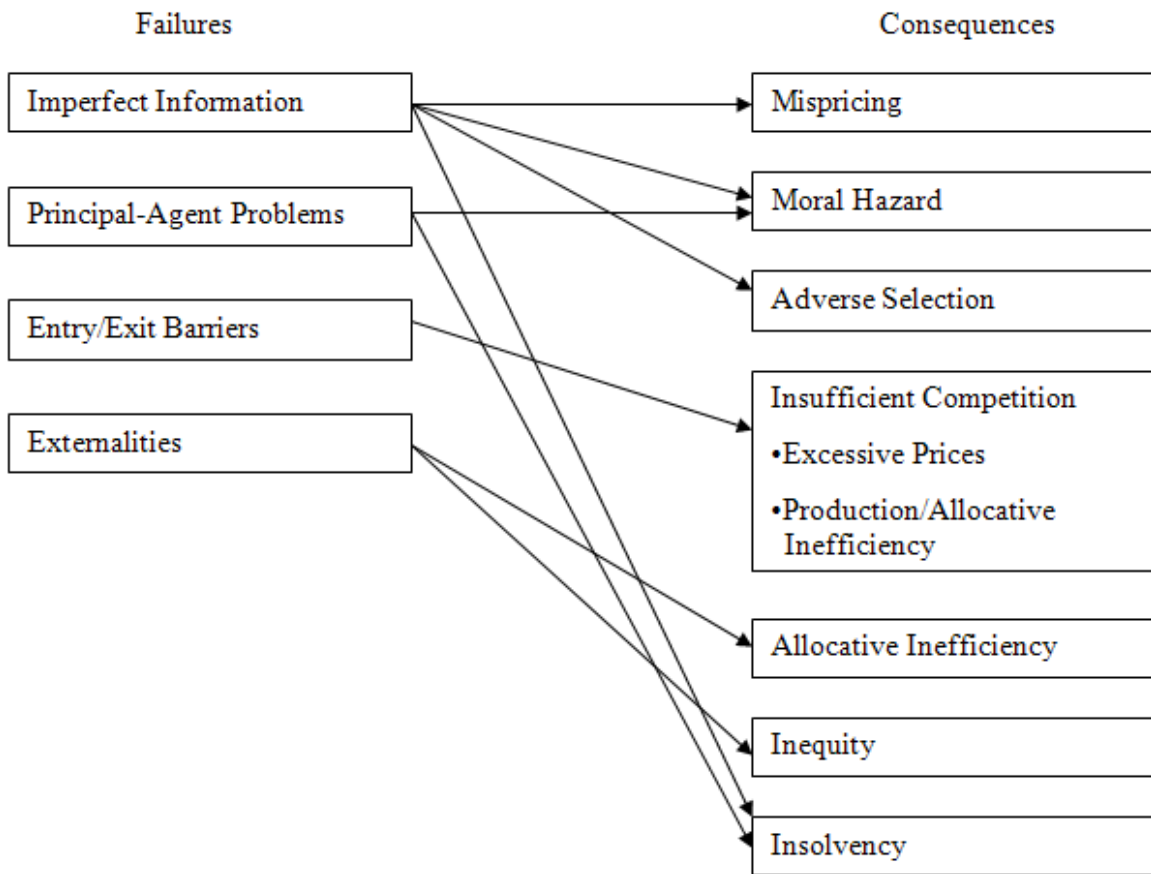
1. Market Problems and Market Failures

The economic foundation for regulation is based on the concept of **market failure**. Market failures constitute violations of the conditions of workable competition, such as entry and exit barriers, firm market power, and imperfect information. **Market problems** (i.e., high prices, unavailability of coverage, insolvencies, etc.) can be a consequence of a market failure or other factors that affect a market that is structurally competitive. In other words, not all conditions perceived as market problems are necessarily caused by a market failure. For example, high insurance prices may be the natural result of increasing claim costs driven by external factors and not the malfunctioning of the market per se. It is important to determine the underlying cause of market problems to determine the appropriate regulatory response. Figure 1 summarizes potential insurance market failures and their consequences.

In theory, regulation should be used primarily to remedy market failures and not necessarily market problems that are caused by other external forces. The basic premise underlying the need for regulation is that market failures can diminish the efficiency and equity of market outcomes and harm the public interest. The purpose of regulation then is to correct market failures, or at least minimize their negative effects, and improve technical and allocative efficiency and equity.¹ This assumes that regulators have good information and can determine and implement the correct market solution.

¹ The term “equity” can mean different things to different people. In insurance, some might equate equity with “actuarial fairness”, i.e., insureds pay premiums commensurate with their relative risk. Others, however, might argue that equity means that every insured pays the same premium (regardless of his or her relative risk) or that insureds are charged premiums that represent an equivalent percentage of their incomes.

Figure 1
Market Failures and Consequences



2. Regulatory Remedies for Insurance Market Failures

Insurance regulation should be principally targeted towards correcting market failures that would otherwise cause insurers' to incur an excessive risk of insolvency and/or engage in market abuses that hurt consumers. The public interest argument for the regulation of insurer solvency derives from inefficiencies created by costly information and principal-agent problems (Munch and Smallwood, 1981).² 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. 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. This represents what economists call a principal-agent problem in that the principals – policyholders – may have different interests than their agents – insurers – and face some difficulty in monitoring and controlling insurers' behavior.³

Thus, in the absence of regulation, imperfect consumer information and principal-agent problems would result in an excessive number of insolvencies and excessive insolvency costs. Solvency regulation is intended to limit the insurers' insolvency risk in accordance with society's preference for safety. Regulators limit insolvency risk by requiring insurers to maintain a minimum amount of capital and meet other financial requirements.

Limiting insolvency risk is a different objective than preventing insolvencies. Limiting insolvency risk implies that some insurers may become insolvent. This is inherent in a competitive market where firms must have the opportunity to fail. In order to guarantee that no insolvencies would occur, the government would have to impose extremely high capital requirements and significantly constrain insurers' investments and other transactions to effectively reduce the probability of insolvency to zero. The result would be high insurance prices and inefficient markets. This is impractical and a more reasonable objective is for regulators to reduce the cost of insolvencies to some

² Costly information refers to the fact that it is costly for consumers to acquire information about the financial condition of an insurer and the relative value of its products in relation to its prices.

³ Principal-agent problems refer to the difficulty that an insured faces in monitoring and controlling the activities and financial risk of an insurer, once the insured has signed a contract with the insurer and paid premiums for coverage of future claims and benefit obligations. This is a problem when consumers may have different objectives and incentives than insurers. For example, insureds may place a higher value on

appropriate minimum that represents an acceptable tradeoff with the cost and availability of insurance.

The traditional explanation for regulation of insurance prices also involves costly information and solvency concerns (Joskow, 1973; Hanson, et. al., 1974). Insurers' incentive to incur excessive financial risk and even engage in "go-for-broke" strategies may result in inadequate prices. Some consumers will 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 position. Thus, it is argued that regulators must impose a floor under prices to prevent the market from imploding. 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.

The rationale offered for government restrictions on insurance price increases is that consumer search costs impede competition and lead to excessive prices and profits (Harrington, 1992). Further, constraints on consumer choice and unequal bargaining power between insurers and consumers, combined with inadequate consumer information, can make consumers vulnerable to abusive marketing and claims practices of insurers and agents. According to this view, the objective of regulation is to enforce a ceiling that will prevent prices from rising above a competitive level and to protect consumers against unfair market practices. The argument for rate regulation implies that insurance markets are not sufficiently competitive to ensure competitive prices in the

an insurers' ability to meet its claims obligations while the insurer may be willing to sustain a higher level of financial risk in order to increase profits.

absence of regulation. This is a contention that many economists, including the author, believe is invalid given the empirical evidence of strong competition in most insurance markets. In addition, the public may express a preference for regulatory policies that seek to achieve certain market outcomes consistent with social norms or objectives, but differ from the outcomes that would occur in a competitive market unrestrained by regulation.⁴

II. Regulatory Institutions

An extensive institutional structure has developed to perform insurance regulatory functions in the U.S. This institutional structure is primarily based within the insurance departments of each state and their respective laws and regulations, policies and procedures, personnel, and physical facilities. In addition, the National Association of Insurance Commissioners (NAIC) serves as a vehicle for the individual state regulators to coordinate their activities and share resources to achieve mutual objectives. This section describes these various institutions and the important roles they play.

A. Brief History of Insurance Regulation in the U.S.

The current state regulatory framework for insurance has its roots in the early 1800s when insurance markets were generally confined to a particular community.⁵ For fire insurance companies, the high concentration of risk and the occurrence of large conflagrations led to highly cyclical pricing and periodic shakeouts when a number of property-liability companies would fail after a major fire (Hanson, et. al., 1974). Life

⁴ 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.

insurers became notorious for high expenses, shaky finances and abusive sales practices (Meier, 1988). The local orientation of insurance markets at the time led municipal and state governments to establish the initial regulatory mechanisms for insurance companies and agents to address these problems and abuses.

Government control of insurers was initially accomplished through special legislative charters and discriminatory taxation, but this proved to be an inefficient mechanism as the number of companies grew and the need for ongoing oversight became apparent (Meier, 1988). Insurance commissions were formed by various states to license companies and agents, regulate policy forms, set reserve requirements, police insurers' investments, and administer financial reporting.⁶ Price regulation in the early 1900s was essentially confined to limited oversight of property-liability industry rate cartels.

Through the years, insurance department responsibilities grew in scope and complexity as the industry evolved. Two major forces appear to have heavily influenced the evolution of insurance regulatory functions and institutions. One factor has been the increasing diversity of insurance products and the types of risks that insurers have assumed. The other factor is the geographic extension of insurance markets with a number of carriers operating on a national and international basis.

B. Role and Authority of State Insurance Regulators

Every state and U.S. territory has a chief government official who is responsible for regulating insurance companies and markets. This individual has the authority and responsibility to ensure that insurance companies do not incur excessive insolvency risk,

⁵See Hanson, et. al., 1974; Lilly, 1976; and Meier, 1988 for reviews of the history of insurance regulation.

⁶New Hampshire appointed the first insurance commissioner in 1851.

nor treat policyholders unfairly. More specifically, insurance commissioners regulate insurers': admission or licensing; solvency and investments; reinsurance activity; transactions among affiliates; prices; underwriting; claims handling; and other market practices. Regulators also oversee producer licensing and market practices, along with certain other areas related to insurance company and market functions. However, it should be understood that insurance commissioners' authority is limited in some respects and that various other public and private institutions are part of the insurance regulatory system. Regulators operate within a broader governmental framework that influences and constrains their actions. The delegation of the primary regulatory authority to the states (rather than the federal government) in insurance is also somewhat unusual relative to how other financial institutions are regulated. The history of state and federal roles in insurance regulation is discussed further below.

Most commissioners are appointed by the governor (or by a regulatory commission) for a set term or "at will", subject to legislative confirmation. Twelve states elect their insurance commissioners who are autonomous in the sense that they do not take orders from the governor but they must still cooperate with the administration in order to achieve their objectives. Elected commissioners directly seek voters' political support, while appointed commissioners do this indirectly as part of the governor's administration.

Commissioners can exert considerable control over insurers' conduct through the admission and licensing process. Insurers who fail to comply with regulatory requirements are subject to losing their authorization to sell insurance through the suspension or revocation of their license or certificate of authority. Commissioners may

exact fines for regulatory violations, which serves as a further financial inducement for compliance. Commissioners also may intervene and seize companies that are deemed to be in hazardous financial condition. These measures give regulators considerable leverage in forcing insurers to comply with insurance laws and regulations. In addition, insurance commissioners can exercise public and political influence in their visible role as consumer protectors and insurance experts. The governor and legislature typically look to the commissioner for guidance on key policy issues and legislation affecting insurance.

At the same time, insurance commissioners are not autonomous and face a number of constraints in exercising their authority. Most importantly, regulators must act within the framework of insurance laws enacted by the legislature. Regulations promulgated by the commissioner are subject to review and approval by the legislature in some states. Regulatory actions are also subject to review and enforcement by the courts. Further, the legislature and the courts can take independent actions that affect insurance markets, which may or may not be in the best interests of consumers and the public.

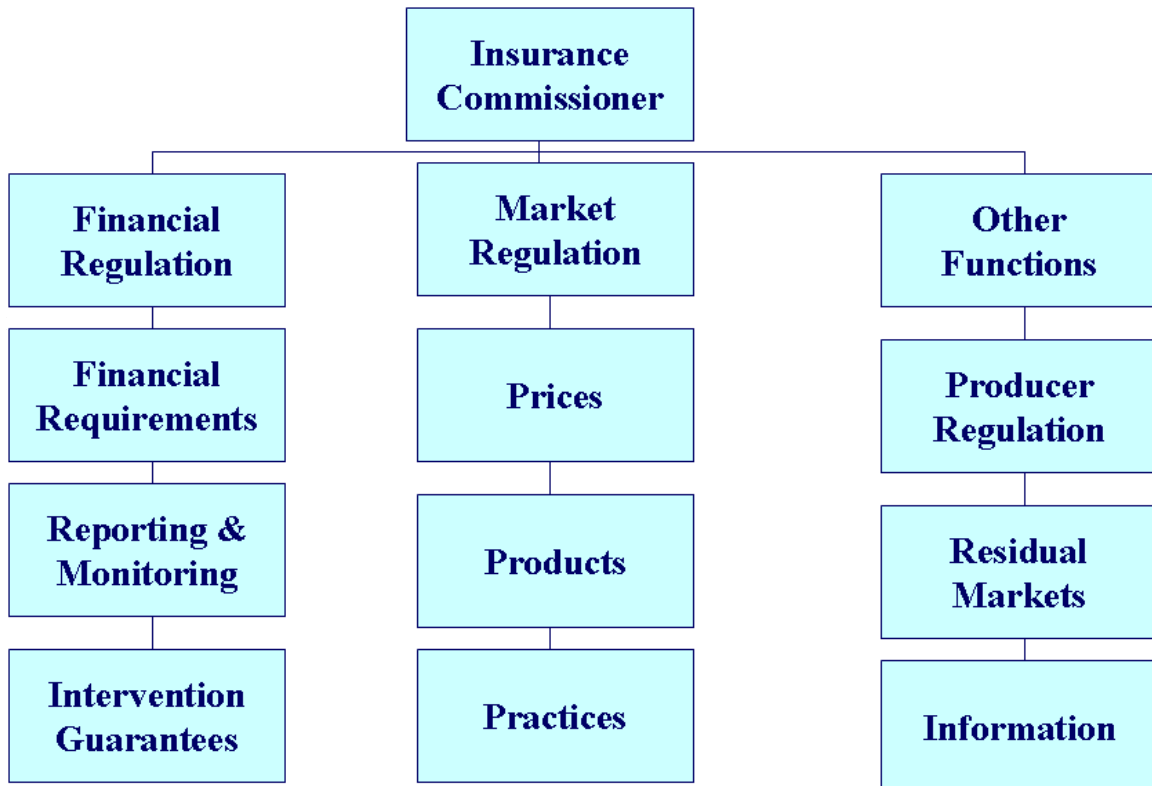
In addition, resource constraints and the difficulties of supervising companies operating in multiple jurisdictions have caused states to defer primary solvency regulatory authority to the domiciliary commissioner (i.e., the commissioner in the state where an insurer is domiciled or incorporated). Non-domiciliary regulators still can exert considerable influence on non-domiciliary insurers through the regulators' ability to deny entry to their states' markets.⁷

⁷ The high degree of interdependence among states in regulating multi-state insurers is caused by the significant amount of business written in each state by non-domestic companies.

C. Principal Insurance Regulatory Responsibilities

For the purpose of this reading, insurance regulatory responsibilities are divided into two primary categories: 1) solvency or financial regulation; and 2) market regulation. Solvency regulation seeks to protect policyholders against the risk that insurers will not be able to meet their financial obligations. Market regulation attempts to ensure fair and reasonable insurance prices, products and trade practices. Solvency and market regulation are inextricably related and must be coordinated to achieve their specific objectives. Regulation of rates and market practices will affect insurers' financial performance and solvency regulation constrains the prices and products that insurers can reasonably offer. The activities and policies associated with these two areas of regulation are summarized in Figure 2 and described in greater detail in Sections III and IV.

Figure 2
Insurance Regulatory Functions



With the exception of solvency oversight by their domiciliary jurisdiction, reinsurers are not generally subject to direct financial and market regulation. Reinsurers are, however, regulated indirectly through the states' regulation of the primary insurers that are ceding business. Regulators control whether a ceding insurer can claim credit for reinsurance on its balance sheet, which is conditioned on whether the reinsurer meets certain regulatory and/or collateral requirements imposed by regulators.⁸

Insurance producers (i.e., agents and brokers) also are subject to regulation. Producers must be licensed to sell insurance in a state and must comply with various laws and regulations governing their activities. State laws require most insurance transactions to be conducted by licensed producers. Regulators monitor producers' compliance with regulatory requirements and can rescind or suspend a producer's license or exact fines if the producer fails to comply.

D. The Federal Government

Tension between the federal government and the states over the regulation of insurance dates back to the mid-1800s (see Kimball and Heaney, 1995).⁹ This tension is created by the interstate operation of many insurers and their significant presence in the economy. On numerous occasions, the federal government has sought to exert greater control over the industry and the states have fought back aggressively to hold on to their authority. The primacy of the states' authority over insurance was essentially affirmed in various court decisions until the Southeastern Underwriters case in 1944. In that case, the

⁸ The NAIC has recently adopted a new framework for the regulation of reinsurance that changes the rules that govern the extent to which ceding companies can claim accounting credit for reinsurance transactions which is discussed in Section III.

U.S. Supreme Court ruled that the commerce clause of the U.S. Constitution did apply to insurance and that the industry was subject to federal antitrust law. This decision prompted the states and the industry to support the enactment of the McCarran-Ferguson Act in 1945, which delegated regulation of insurance to the states, except in instances where federal law specifically supersedes state law.

The federal government has influenced state insurance regulatory policy and institutions in a number of ways. In several instances, Congress has instituted federal control over certain insurance markets or aspects of insurers' operations that were previously delegated to the states. In other cases, the federal government has established insurance programs that are essentially exempt from state regulatory oversight. Even the threat of such interventions has spurred the states to take actions to forestall an erosion of their regulatory authority.¹⁰

In a few instances, the federal government has set regulatory standards that the states are expected to enforce. In the case of Medicare supplement insurance, for example, Congress enacted loss ratio standards that the states were required to adopt to avoid relinquishing their oversight authority to the federal government. Additionally, Congress has significantly constrained state regulatory control over certain types of insurance entities, such as risk retention groups and employer-funded health plans. This has made market regulation more difficult when bogus groups claim federal preemption to avoid state oversight. Finally, federal policies in a number of other areas such as

⁹See also Meier (1988) and Advisory Commission on Intergovernmental Relations (1992) for a review of various attempted federal interventions into insurance regulation.

¹⁰For example, when the failure of a number of substandard auto insurers prompted the introduction of federal legislation to create a national guaranty fund system in 1969, the NAIC moved quickly to adopt model guaranty fund acts for property/casualty and life/health insurers which were subsequently enacted by many states. A significant rise in the number of insurer insolvencies in the 1980s led to a series of

antitrust, international trade, law enforcement, taxation and the regulation of banks and securities have significant implications for the insurance industry and state regulation.

Within the last two decades, an increasing number of insurers support a federal regulatory system for insurance (Grace and Klein, 2009). Legislation has been introduced in the Congress that would establish an Optional Federal Charter (OFC) for insurance companies and agents. Under this system, insurers and agents could choose to be regulated by the federal government and essentially exempt from state regulation. Insurers and agents that would not opt for federal regulation would continue to be regulated by the states. The OFC proposal has received considerable political opposition from the states, single-state and regional insurers and independent agents. Consequently, the prospects for the enactment of OFC in the near future are dim. However, proponents of an OFC will continue to push their case and the debate over the establishment of a federal regulatory system for insurance will continue.

E. Regulatory Resources

The adequacy of state insurance department resources has been an area of considerable concern with allegations that departments lack sufficient experienced staff to effectively police the industry. The size of insurance departments varies significantly depending on the size of their markets and other factors. In 2008, the number of state insurance department personnel ranged from 28 in South Dakota to 1,699 in Texas.¹¹ The insurance departments in the four U.S. territories have smaller staffs than the states. Total

Congressional hearings on the adequacy of state regulation. This helped to prompt the states to implement a number of improvements in their financial regulation of insurers.

¹¹ Unless indicated otherwise, figures on state insurance departments were obtained from the NAIC's *Insurance Department Resources Report 2008*.

full-time equivalent staff for all departments combined amounted to 11,906. Insurance department staff includes actuaries, financial examiners and analysts, rates and forms analysts, market conduct examiners, consumer service personnel, attorneys, fraud investigators, and systems analysts.

For fiscal year 2010, state department budgets ranged from \$1.8 million in South Dakota to \$556.9 million in New York, with a total combined budget for all departments of approximately \$1.9 billion. The size and budget of state insurance departments tend to vary with the volume of business that they regulate, although there is not a perfect correlation. States that have more domiciliary companies, regulate more intensively, or provide special services (e.g., in-house liquidators) tend to have larger staffs and budgets. Public and legislative support for insurance regulation also affects department resources. Smaller states can be at a disadvantage in performing certain regulatory functions, but they can draw on assistance from larger states and the NAIC. Insurance departments obtain their funding, directly or indirectly, from: fees; assessments; and premium, retaliatory and other business and income taxes.

F. National Association of Insurance Commissioners

The states have used the National Association of State Insurance Commissioners (NAIC) to coordinate their regulation of this diverse national and international industry.¹² The NAIC is a private, non-profit association of the chief insurance regulatory officials of the 50 states, the District of Columbia, and the four territories. It was established in 1871 to coordinate the supervision of multi-state companies within a state regulatory

¹² The NAIC website, at www.naic.org, is a valuable source of information on regulation and also provides a link to the website for each state insurance department.

framework, with special emphasis on insurers' financial condition. It expanded its activities to include market regulatory issues as these issues became more prominent. The NAIC functions in an advisory capacity as well as a service provider for state insurance departments.

Some critics of state insurance regulation have pointed out that the NAIC is a voluntary organization and cannot compel states to adopt its model laws or take any other action for that matter. Other critics argue that the NAIC operates as a quasi-governmental entity that exercises too much influence. The reality is that the NAIC is the states acting collectively to protect consumers. In other words, the NAIC simply provides a vehicle by which the individual states can coordinate the exercise of their specific regulatory authorities.

Commissioners use the NAIC to pool resources, discuss issues of common concern, and align their oversight of the industry. Collective action can enhance as well as constrain the power of individual states. The credence given to NAIC policy positions and its ability to organize its members are substantial levers that help to standardize insurance regulatory policy across the country where standardization is deemed to be beneficial. The NAIC develops model legislation and coordinates regulatory policy through a system of committees, task forces and working groups that functions much like a legislature.

The NAIC also works with the federal government and other organizations of state officials, such as the National Conference of State Insurance Legislators (NCOIL).¹³ For example, the NAIC played a major role in representing state insurance regulators in

¹³ Interactions between the NAIC and NCOIL are particularly important in achieving consensus on legislation that must be enacted at the state level.

the negotiation of the Graham-Leach-Bliley Act (GLBA) on financial services regulation and is leading state efforts in responding to the legislation. At the same time, given its voluntary nature, the NAIC is relatively circumspect with regards to when and how it uses its levers. Ultimately, each state determines what actions it will take as only the states have the regulatory authority to govern insurers and insurance markets.

The future role of the NAIC will be a major topic of discussion in the coming years. The GLBA contemplates a functional scheme in which the insurance activities of non-insurers will be overseen by state insurance regulators, in coordination with other financial regulators. Given the disparate views on the desirability of federal insurance regulation, many will look to the NAIC to help overcome some of the perceived deficiencies of state regulation. Historically, many states and insurers have been reluctant to imbue the NAIC with any formal regulatory authority. However, they may view this as a preferable alternative to federal regulation. On the other side, groups interested in greater national uniformity may be willing to accept an empowered NAIC as a first or second best option.

In recent years, the NAIC has undertaken a number of initiatives to increase state regulatory efficiency and reduce some of the costs that insurers face in dealing with multiple regulatory jurisdictions (Klein, 2005). These initiatives include systems for the electronic filing of rates and policy forms, expedited insurer licensing, producer licensing, and multi-state filings of common life insurance policy forms.

III. Financial Regulation

Protecting policyholders and society in general against excessive insurer insolvency risk should be the primary goal of insurance regulation. Regulators protect policyholders' interests by requiring insurers to meet certain financial standards and to act prudently in managing their affairs. Solvency regulation polices a number of aspects of insurers' operations, including: 1) capitalization; 2) pricing and products; 3) investments; 4) reinsurance; 5) reserves; 6) asset-liability matching; 7) transactions with affiliates; and 8) management.

A. Financial Requirements

1. Capital Standards

Capital standards are a critical requirement in solvency regulation. Capital and surplus provide a cushion against unexpected increases in liabilities and decreases in the values of assets. Capital also is intended to fund the expenses of a rehabilitation or liquidation of an insurer with minimal losses to policyholders and claimants. Insurers are required to have a certain amount of capital and surplus to establish and continue operations. When an insurer's capital and surplus falls below the minimum standard, it is considered to be legally **impaired**. When an insurer's liabilities exceed the value of its assets, i.e., its capital and surplus is negative, it is **insolvent**. Regulators also may seize a company if they can show that it is in hazardous condition and will ultimately be unable to meet its obligations to policyholders.¹⁴ The states have fixed minimum capital and surplus requirements as well as risk-based capital (RBC) requirements.

¹⁴ All states have a battery of laws and regulations similar to NAIC model acts that authorize the insurance commissioner to take action against companies deemed to be in hazardous condition. Regulators have been

State fixed minimum capital and surplus requirements for stock companies range from \$500,000 to \$6 million depending on the state and the lines that an insurer writes. Initial capital and surplus standards for new insurers are often higher than maintenance standards for insurers that have been in business for several years. Multi-line insurers are generally required to hold more capital than mono-line insurers. Capital requirements also tend to be higher for insurers writing casualty lines. The typical state fixed minimum capital requirement for a multi-line insurer is in the area of \$2 million.

Fixed minimum capital requirements have been generally intended to ensure that a company has adequate surplus to initiate operations and fund receivership expenses in the event of insolvency. As insurers have grown over time and incurred increasing risk, it became apparent to regulators that fixed minimum requirements were inadequate to provide an adequate cushion for most insurers. Some states responded by increasing their fixed capital requirements when insolvencies increased in the late 1980s. However, the most important development has been variable risk-based capital (RBC) requirements.

The concept of **risk-based capital** recognizes that insurers range widely in size and the types of risks they assume which make fixed minimum capital standards inadequate for many companies. In practice, regulators can and do take action against troubled insurers before they fall below the minimum standard, but such actions are subject to legal challenges and regulators must convince a court that an insurer is in unsafe condition. The NAIC adopted model minimum RBC requirements for life-health insurers in 1992 and for property-liability insurers in 1993, which are intended to partially correct the deficiencies of fixed standards. The NAIC developed RBC

criticized for moving too quickly in some instances and not quickly enough in others. The appropriate nature and timing of regulatory intervention is a complex issue that does not lend itself to a simplistic, ex

requirements specific to health insurance in 1997. An insurer's RBC requirement is determined using a formula that applies factors to certain accounting values of the insurer.

An insurer is required to meet the greater of its RBC standard or the fixed minimum capital requirements of the states in which it is licensed to do business. Under the RBC model law, certain company and regulatory actions are required if a company's total adjusted capital (TAC) falls below a certain level of risk-based capital.¹⁵ These actions become increasingly severe the greater the deficiency of an insurer's TAC relative to its RBC requirement.

RBC is intended to be a **minimum** regulatory capital standard and not necessarily the amount of capital that an insurer would want to hold to meet its safety and competitive objectives. The NAIC's life-health RBC formula encompasses four major categories of risk: 1) asset risk; 2) insurance or pricing risk; 3) interest rate risk; and 4) business risk. The risks addressed by the NAIC's property-liability formula differ in some respects and include: 1) asset risk; 2) credit risk (uncollectible reinsurance and other receivables); 3) underwriting (pricing and reserve) risk; and 4) off-balance sheet risk (e.g., guarantees of parent obligations, excessive growth). The health insurance RBC requirements developed by the NAIC are intended to provide more refined RBC amounts that reflect the relative risks involved with different types of health insurance.

post evaluation.

¹⁵ An insurer's total adjusted capital is essentially equal to its reported surplus with minor adjustments.

2. Reserve Requirements

In addition to capital requirements, insurers are subject to other regulations with respect to their financial structure and operations. Insurers are mandated to set aside reserves for future benefit payments and potential losses on investments. Reserve requirements tend to be more prescriptive for life insurers, with respect to both policy and investment reserves. With the exception of workers' compensation, the rules are less specific for property-casualty insurer reserves. Insurers are required to file actuarial opinions annually that address the adequacy of their reserves.

3. Investment Restrictions

The high-risk investment strategies of some insurers and the casualties that occurred when the junk bond and real estate markets declined in the early 1990s led regulators to intensify their oversight of insurers' investments. In 1996, the NAIC adopted a comprehensive model law covering all insurer investments. This model law proscribes relatively detailed and specific limitations on and requirements for various types of assets. These include certain limits on the amounts or relative proportions of different assets that insurers can hold to ensure adequate diversification and limit risk. These provisions vary somewhat between life-health and property-liability insurers, recognizing differences in their liability structures and investment needs. A second model act was later adopted (as an alternative) that provides insurers greater discretion using a "prudent person" approach. The states have been enacting investment laws based on the first or second model, or a combination of both. Due to the asset problems that some insurers encountered due to the recent financial crisis regulators will likely revisit the

regulations governing investments and may impose additional constraints on certain types of assets such as their investments in securities backed by subprime mortgages.

4. Other Financial Requirements

Other statutes and regulations pertain to different aspects of insurers operations. Holding company laws regulate transactions between affiliated companies, including the payment of dividends from a subsidiary to a parent. Insurers are prohibited from improper delegation of authority to managing general agents (MGAs) in the areas of pricing, underwriting and paying claims. Delegation of these functions to MGAs without proper oversight has contributed to a number of insurer insolvencies. In general, insurance company managers are required to act prudently in protecting policyholders' interests and regulators are authorized to seize control if management actions threaten a company's solvency.

The regulation of reinsurance transactions was strengthened in the late 1980s. In 1989, the NAIC adopted a model law that tightened requirements for insurers to receive financial credit for ceded reinsurance. In order for the ceding insurer to receive credit, the reinsurer must be **authorized** or post security to cover its obligations, should it fail. To be authorized, a reinsurer must be licensed in at least one state and have capital and surplus of at least \$20 million as well as meet other requirements. The credit that a ceding carrier receives also is reduced for uncollectible and overdue reinsurance payments. Model regulations prohibiting "surplus relief" schemes and limiting fronting arrangements were adopted by the NAIC in 1991 and 1993, respectively. Additional models were adopted that regulate the activities of reinsurance intermediaries and managing producers.

The NAIC recently adopted a new framework for determining reinsurers' collateral requirements. Under this new framework, U.S. insurers may qualify as "national reinsurers" regulated by their home state. Non-U.S. reinsurers may qualify as "port of entry" (POE) reinsurers by using an eligible state as a port of entry. A POE reinsurer will be subject to oversight by its port of entry supervisor. Both national reinsurers and POE reinsurers will be subject to collateral requirements that will be scaled according to something resembling a financial strength rating. Reinsurers receiving the highest rating will not be required to post collateral. U.S. and non-U.S. reinsurers that do not become qualified as national or POE reinsurers will remain subject to current state laws and regulations governing credit for reinsurance. An NAIC Reinsurance Review Supervision Division (RRSD) will be established to implement the new framework, including determining those states that will qualify as the supervisors for national and POE reinsurers.

B. Financial Monitoring

Fundamentally, the objective of financial monitoring should be to ensure that insurance companies meet regulatory standards and alert regulators if actions need to be taken against a company to protect its policyholders (Klein, 2009). Ideally, this monitoring should not only consider the current financial condition of an insurer, but also its financial risk and potential for encountering financial difficulty in the future. Financial monitoring encompasses a broad range of regulatory activities including financial reporting, early warning systems, financial analysis and examinations. The annual and quarterly financial statements filed by insurers serve as the principal source of

information for the solvency monitoring process. Regulators receive other confidential reports and they may compel insurers to provide other information as necessary to assess their financial condition.¹⁶

Insurance departments typically subject financial statements to review by an in-house financial analyst or examiner who analyzes the financial condition of the insurer and determines whether regulatory action is warranted. The NAIC also scrutinizes insurers' financial statements and disseminates financial ratio results to insurance departments. Additionally, the NAIC has a special financial analysis division and regulatory working group that monitor larger, multistate insurers and communicates with the states regarding companies that may be in financial difficulty.

1. Statutory Accounting

Insurance regulatory accounting is a unique animal. Insurance companies are required to file financial statements with insurance regulators in accordance with what are called statutory accounting principles (SAP), which differ somewhat from Generally Accepted Accounting Principles (GAAP). Statutory accounting seeks to determine an insurer's ability to satisfy its obligations at all times, whereas GAAP measures the earnings of a company on a going-concern basis from period to period. Under SAP, most assets and liabilities are valued conservatively and certain non-liquid assets, e.g., furniture and fixtures, are not admitted in the calculation of an insurer's surplus. Statutory rules also govern such areas as how insurers should establish reserves for invested assets

¹⁶State laws authorizing the insurance commissioner to conduct examinations of insurers generally authorize the commissioner to look at all books and records of a company at any time. For example, Section 4 of the NAIC's Model Law on Examinations requires that insurers provide examiners with "free

(life insurers only) and claims and the conditions under which they can claim credit for reinsurance ceded. In general, insurance financial reporting requirements in the U.S. have been greatly expanded in recent years to provide more detailed and accurate information to assess insurers' financial condition. The NAIC also has recently adopted materials that provide greater guidance on statutory accounting rules.

2. Financial Analysis and Early Warning Systems

States typically prioritize the review of their domiciliary companies and any companies that require expedited scrutiny. Most departments utilize some system of financial ratios or other tools to screen and prioritize insurers for analysis. Regulators also utilize NAIC financial information systems including the Insurance Regulatory Information System (IRIS), which includes the Financial Analysis Solvency Tools (FAST) system, and other reports. Various additional sources of information may be tapped including: Securities and Exchange Commission (SEC) filings; claims-paying ability ratings; complaint ratios; market conduct reports; correspondence from competitors and agents; news articles; and other sources of anecdotal information. Regulators have enhanced their solvency monitoring activities to facilitate more timely regulatory action against troubled insurers.

Since the early 1970s, the NAIC and the states have utilized IRIS to monitor insurers' financial condition at a national level and identify those insurers requiring further regulatory attention. Companies' financial data are first processed through a statistical phase consisting of a series of 12 financial ratios (which differ among property-

access to all books, records, accounts, papers, documents, and any or all computer or other recordings relating to the property, assets, business and affairs of the company being examined.”

casualty and life-health insurers), as well as a series of additional screening criteria. Companies deemed to be "first priority" are followed up by the NAIC's Examination Oversight Task Force, which takes action if the domiciliary state fails to do so. Insurers' IRIS ratio results (and unusual value parameters and priority status) also are available to regulators over the NAIC network. Ratio results and unusual value parameters are available to the public through a published report but insurers' priority status is not published.

The IRIS ratios continue to be refined over time based on regulators' experience with troubled insurers. In 1990, IRIS was expanded to encompass a new solvency-screening model and an analytical process to facilitate peer review of the domiciliary regulation of "nationally significant" insurers and to assist insurance departments in prioritizing their financial analysis. The objective of the NAIC's peer review process, as exercised through its Financial Analysis Working Group (FAWG), is to ensure that domiciliary regulators are taking effective action with respect to larger, multistate insurers that are may be in financial difficulty. Currently, nationally significant insurers are deemed to be those companies that write business in 17 or more states and have gross premiums (direct plus assumed) written in excess of \$50 million for life/health companies and \$30 million for property-liability insurers.

The NAIC's Financial Analysis Division subjects insurers' financial statements to a computerized analytical routine, FAST, which prioritizes companies for further analysis. FAST consists of a series of approximately 20 financial ratios based on annual and quarterly statement data, but, unlike the original IRIS ratios, it assigns different point values for different ranges of ratio results. A cumulative score is derived for each

company, which is used to prioritize it for further analysis. Annual and quarterly scores are computed and reviewed. Certain companies are classified as priority based on their score and a specified cut-off point. Like the IRIS ratios, the FAST ratios continue to be refined over time. Regulators also utilize additional analysis applications based on FAST to aid their reviews of insurers.

3. Examinations

Examinations are a fundamental component of the solvency monitoring process. Historically, in insurance regulation, primary reliance had been placed on the comprehensive triennial examination, although regulators have had the authority to examine companies whenever they deem necessary. Some insurers may need to be examined more frequently than every three years while others may need to be examined less frequently. State regulators are increasing their reliance on the use of targeted examinations which are limited in scope and which may be called because of special circumstances or in lieu of a regular comprehensive examination. The NAIC further encourages the use of "association" or "zone" examinations in which various states participate to consolidate efforts and avoid duplicative and redundant examinations of the same company.

Independent CPA audit requirements also represent a significant development designed to improve the quality of financial reporting and monitoring. Annual statement instructions require all insurers to have an annual audit performed by an independent certified public accountant and file an audited financial report as a supplement to their

annual statement on or before June 1 for the preceding calendar year. This helps to ensure the accuracy of the financial information reported by insurers.

C. Intervention and Guaranty Associations

1. Intervention and Receiverships

The nature of the appropriate regulatory action for a troubled insurer varies depending on the circumstances but the essential purpose is to prevent or minimize losses and to protect policyholders. Regulators first seek to rehabilitate troubled insurers if possible, and sell or liquidate them if rehabilitation is not feasible or unsuccessful. There are two levels of regulatory actions: 1) actions to prevent a financially troubled insurer from becoming insolvent; and 2) delinquency proceedings against an insurer for the purpose of rehabilitating or liquidating the insurer. Actions within the first category include hearings/conferences, corrective plans, restrictions on activities, notices of impairment, cease and desist orders, and supervision. Some of these actions may be conducted informally, others require formal measures. Similarly, some actions against companies may be confidential and others may be publicly announced. Sales or mergers of troubled insurers are often negotiated by regulators to avoid market disruptions. Regulators indicate that a large number of troubled insurers subject to regulatory action are never publicly identified because their problems are resolved before more drastic action is required.

However, if preventative regulatory actions are too late or otherwise unsuccessful and an insurer becomes severely impaired or insolvent, then formal delinquency proceedings will be instituted. These measures can encompass seizure of assets,

rehabilitation, and liquidation. For many insurers, these actions are progressive. A regulator may first seek to rehabilitate a company to maintain availability of coverage and avoid adverse effects on policyholders and claimants, as well as lower insolvency costs. For example, it is often possible to sell a troubled life insurer's book of business to another insurer, which decreases insolvency costs. However, the regulator may ultimately be forced to liquidate the company if rehabilitation does not prove to be feasible. Regulators typically need court approval for such actions, which may be challenged by the troubled insurer.

2. Guaranty Associations

State guaranty associations have been established to protect policyholders, claimants and beneficiaries against financial losses due to insurer insolvencies. While most stakeholders support some form of insolvency guaranties, some experts criticize the current system for creating a significant moral hazard problem (Cummins, 1988). Fundamentally, the purpose of an insolvency guaranty law/association is to cover an insolvent insurer's financial obligations, within statutory limits, to policyowners, annuitants, beneficiaries and third-party claimants.¹⁷ Most states limit coverage of property-liability claims and death benefits to \$300,000. Health insurance claims and cash values on life insurance policies and annuities are typically limited to \$100,000. There are no limits on workers' compensation claims. All licensed insurance companies

¹⁷Most states have separate property-liability and life/health guaranty associations although several states have combined associations with separate assessments. Current information on property-liability guaranty funds can be obtained from the National Conference on Insurance Guaranty Funds (NCIGF) and information on life/health funds can be obtained from the National Organization of Life and Health Guaranty Associations (NOLGHA).

are required to be members of the state guaranty association. However, most states exclude HMOs from guaranty association participation.

Guaranty associations are financed by assessments on member insurers' premiums written in covered lines of business in a state subject to an annual cap (usually one or two percent of premiums). With the exception of New York's property-liability guaranty fund, assessments are made after an insolvency occurs to cover the claims of the insolvent insurer. New York has a pre-insolvency assessment property-liability guaranty fund. Assessments also are made to cover the administrative expenses of guaranty associations.

Assessments are allocated among states based on the premiums (in covered lines) of the insolvent insurer in each state. The burden of guaranty association assessments are ultimately shared by: 1) all policyholders through higher insurance rates; 2) taxpayers because of state premium tax offsets (in some states) and deductions for federal income taxes; and 3) owners of insurers (Barrese and Nelson, 1994). Generally, guaranty association assessments have remained a small fraction (less than 0.5 percent) of market premiums, but occasionally they reach higher levels, particularly in some states, when there is a spike in insolvency costs (e.g., insolvencies caused by Hurricane Andrew).

D. Financial Regulation Standards and Accreditation

The growing interdependence of the states in regulating multistate insurers, coupled with the varying quality of regulation among the states in the face of increased insurer financial risk, prompted the NAIC to develop a certification program for insurance departments. The goal of the program is to ensure that a state's solvency

regulation meets certain minimum requirements so that other jurisdictions can have a degree of confidence in the state's oversight of its domiciliary companies. The NAIC Policy Statement on Financial Regulation Standards, adopted in June 1989, articulated a comprehensive set of standards designed to establish consistent and effective regulation of the financial condition of insurance companies. The standards go beyond model laws by establishing a composite list of legislative and administrative prerequisites for an effective solvency regulatory program in three areas: 1) laws and regulations, 2) regulatory practices and procedures, and 3) organizational and personnel practices.¹⁸

In order to provide guidance to the states regarding the minimum standards and an incentive to put them in place, the NAIC adopted a formal accreditation program in June 1990. Under this plan, each state's insurance department is reviewed by an independent review team whose job it is to assess that department's compliance with the NAIC's Financial Regulation Standards. Departments meeting the NAIC standards are publicly acknowledged, while departments not in compliance are given guidance by the NAIC on how to bring the department into compliance. If a state is unaccredited, some of its domiciliary companies may consider redomestication to an accredited state.

The accreditation program has significant implications for the effectiveness and efficiency of state solvency regulation of insurance companies. By certifying that a state's regulatory program meets certain minimum requirements, there is greater assurance that its oversight of its domestic insurers is adequate. This promotes efficiency by allowing each state to focus more of its resources on its own domiciliary insurers, which improves the quality of that regulation while avoiding duplicative analysis and examinations of

¹⁸ Initially, it was contemplated that this would serve as a significant incentive for states to become accredited. In practice, this is difficult to prove as almost all states have become accredited. Still,

insurers by non-domiciliary states. Efficiencies also are achieved by using the NAIC as an accrediting body as it would be costly for each state to independently review and certify the regulatory quality of every other state.

It is difficult to quantify the impact of the NAIC accreditation program but there is evidence to suggest that it has had significant effects on the infrastructure for state solvency regulation. Every state has enacted a legislative package designed to achieve compliance with the NAIC standards. Insurance department budgets and staffing have increased at a fast pace despite state fiscal constraints. There also is considerable anecdotal evidence that a number of insurance departments have improved their internal procedures and increased the sophistication of their analysis tools in order to pass muster under the NAIC's accreditation program. As of September 2000, 48 states and the District of Columbia were accredited. Only two states and the four U.S. territories were unaccredited. The challenge will be to maintain a strong and relevant set of standards as the requirements for effective regulation change.

IV. Market Regulation

Market regulation encompasses a diverse set of areas and is approached somewhat differently by the various states. The fundamental objective is to promote the proper functioning of insurance markets to serve the interests of consumers and the general public. Rates and policy forms are subject to some form of regulatory approval in virtually all states. State laws typically require that property-liability and health insurance rates not be inadequate, excessive or unfairly discriminatory and that life insurance premiums should be reasonable in relation to the benefits provided.

accreditation will play an important role in initiatives to diminish redundant regulation by multiple states.

In addition, insurers must obtain approval for the products that they sell and, specifically, the policy forms that they use. Regulators seek to ensure that policy provisions: comply with state law; are reasonable and fair; and do not contain major gaps in coverage that might be misunderstood by consumers and leave them unprotected. Market practices also are subject to regulation where the commissioner polices insurers' and agents' sales and underwriting activities to assure their adherence to certain standards and that claims are paid according to the provisions of insurance contracts. The intention is to prevent abusive practices, e.g., false sales illustrations or the failure to pay legitimate claims on a timely basis that take unfair advantage of consumers.

A. Rate and Form Regulation

Virtually all states have rating laws that require that rates not be excessive, inadequate or unfairly discriminatory. How these standards are interpreted and enforced varies significantly, however. For the personal property-liability lines, 18 states require rates for personal auto and home insurance to be filed and receive prior approval before they go into effect. Other states allow insurers to implement personal lines rates without prior approval, placing greater reliance on competition to regulate prices. These systems typically are “file and use” or “use and file” systems, which allow the regulator to subsequently disapprove the rates if they fail to meet regulatory requirements.¹⁹ Several states also have “flex-rating” laws that do not require prior approval for rate changes unless they exceed certain parameters with respect to the magnitude of a change. With the exception of workers' compensation and medical malpractice, commercial property-

liability lines in many states also are subject to a competitive rating approach. Under such a system, regulators typically retain authority to disapprove rates if they find that competition is not working, although, in practice, such a finding rarely occurs.

In practice, states vary significantly in how they enforce prior approval systems. Some states permit insurers considerable discretion in the rates they charge, while other states, at times, may enforce tight constraints on overall rate levels and the rates for certain groups of insureds. Rate suppression and compression is more likely to occur when claim costs are escalating and insurers file for rate increases.

Research on the effects of rate regulation in property-liability insurance have generally found that prior approval systems do not have a strong effect on premium levels or profitability (Klein, 1995). In other words, markets with competitive rating and prior approval systems tend to perform similarly **on average**. This is consistent with the evidence that most insurance markets are workably competitive. One exception to this finding is where regulators have applied tight price ceilings when claim costs are escalating rapidly. This can lead to insurance availability problems until legislative or regulatory reforms are implemented to reduce costs and premiums. Other aspects of market performance also may be affected by stringent regulation, such as the quality of service.

Premiums for life insurance and annuity products are generally not subject to regulatory approval, although regulators may seek to ensure that policy benefits are commensurate with the premiums charged. Many states also subject health insurance rates to prior approval, with the rest using a file and use system or no provisions for

¹⁹ Many of the laws governing competitive rating systems require the commissioner to show a lack of competition in order to subsequently disapprove a filed rate. State rating laws tend to be based on NAIC

review.²⁰ Typically, however, the states enforce minimum loss ratio requirements for Medicare supplement insurance, long-term care insurance and credit insurance products.²¹

Regulators require insurers to file their policy forms, and may require their prior approval before they can be implemented. In this area, regulators typically look for policy provisions that do not comply with regulatory requirements, provide inadequate coverage, or may be misunderstood by consumers. In such instances, regulators will require policy forms to be revised before an insurer can introduce them into the market or continue selling them if they have been introduced.

B. Market Practices

Responding to consumer complaints and performing market conduct examinations are the primary ways in which insurance departments regulate market practices. Most departments have established toll-free hotlines, Internet web sites, forms, and special consumer services units to receive and handle complaints against insurers and agents and communicate with consumers. Department analysts attempt to determine whether a complaint has merit and may possibly constitute a violation of state laws or regulations.

Market conduct examinations are conducted on a routine basis and also can be triggered by complaints against an insurer and other indicators. Examinations and financial penalties serve to increase insurers' incentives to comply with the law.

model prior approval and competitive rating laws.

²⁰ This pattern may be changing somewhat as states become more active in regulating health insurance rates.

²¹The NAIC maintains charts on the rate regulatory systems of the various states for the different lines.

Examiners review company's policy files and claims files as well as other internal records to ensure that the company is acting in compliance with state laws and regulations.

C. Other Market Regulatory Functions

State insurance departments perform various other functions that are part of or related to their regulatory functions. Insurance commissioners are generally held accountable for the overall performance of insurance markets under their jurisdiction and this leads to a number of activities designed to support market operations. Enhancing consumer information about insurers' prices, products and financial strength is a critical function given the heavy reliance on competition to ensure good market performance. All insurance intermediaries (agents, brokers, solicitors, etc.) involved in selling insurance in a state are required to be licensed and meet certain minimum requirements. In recent years, a number of insurance departments have increased their resources and efforts devoted to detecting and sanctioning insurance fraud. Other functions that may be performed by insurance departments include coordinating market assistance plans, collecting premium taxes and providing public information. Additionally, many states administer or oversee residual market mechanisms for insureds who are not able to obtain coverage in the voluntary market. These mechanisms are most predominant in personal auto and home insurance, and workers' compensation insurance.

V. Potential Effects of Insurance Regulation

A. Solvency Regulation

One of the objectives of this reading is to indicate how differences in regulatory policies can affect market structure and performance. As noted above, more stringent solvency requirements will tend to limit entry into insurance markets and the range of prices and products that insurers can offer. For example, regulators would not allow an insurer to invest 100 percent of its assets in high-risk non-investment grade bonds to support life and annuity products with relatively high crediting interest rates. Consumers, presumably, are willing to accept some solvency restrictions on insurers' financial risk to protect their interest in insurers' ability to meet their obligations. Generally, the entry restrictions imposed by regulators are not a difficult barrier for most companies to overcome. Consequently, concentration in most national and state insurance markets is relatively low and the ease of entry makes these markets highly "contestable".²²

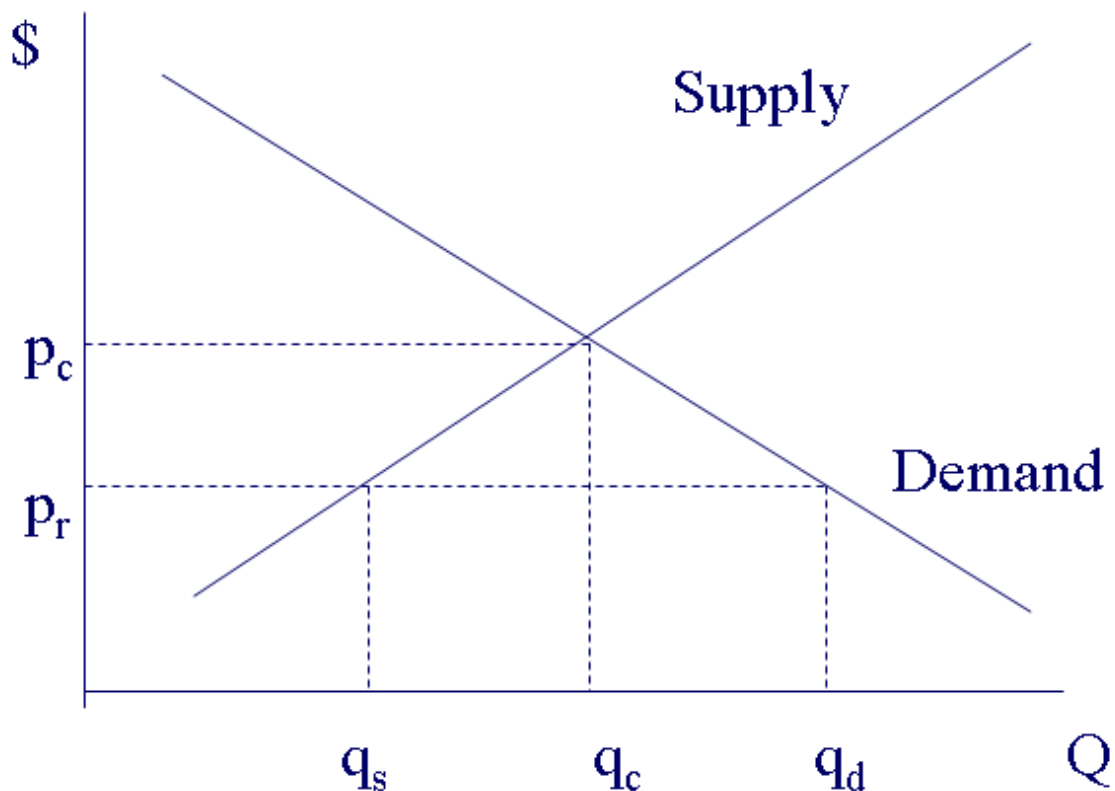
B. Market Regulation

Direct regulation of insurers prices, products and market practices also can affect market conditions, positively or negatively. If insurers are able to exercise market power to raise the market price above the competitive price, then regulators can improve market performance by setting a price ceiling at the competitive level. In practice, this is rarely necessary as the competitive structure of most insurance markets prevents insurers from acquiring significant market power. If regulators set a price ceiling below the competitive market price, then insurers will offer less insurance than consumers will want to buy,

causing availability problems (see Figure 3). In the long run, insurers will be induced to leave the market if they cannot charge a premium that covers their costs and believe that they will sustain losses for the foreseeable future.

As noted above, the rate structure (i.e., the relative rates between different risks) as well as the rate level is regulated in some property-liability lines, such as auto and workers' compensation insurance, as well as health insurance. Ideally, the premium should approximate the expected cost of insuring a given risk, but there are inherent limitations to the precision of any insurance pricing system, regardless of regulatory constraints. Regulators seek to ensure that rate differentials are not unfairly discriminatory. However, that principle may be interpreted and applied differently among states and some have sought to limit rates for certain groups of insureds.

Figure 3
Effects of Regulatory Rate Suppression



assessed back to the voluntary market, forcing a subsidy from voluntary market risks to residual market risks. This, in turn, further discourages insurers from accepting risks in the voluntary market, which increases the growth of the residual market.

Holding rates below costs can have other adverse effects on the market besides causing insurers to exit and decreasing the availability of coverage. Insurers might lower the quality of service they provide. Insurers might also adjust the quality of service by varying the stringency of their claims settlement policy. A tighter claims policy will result in fewer claims being paid as well as lower settlements on some claims that are paid. This is more difficult to do in lines where benefits are set by law. Alternatively, insurers might lower quality and their costs by delaying claims payments, premium refunds and dividends to policyholders. Also, insurers might lower their expenses by reducing other services they provide to insureds.

Another adverse effect of inadequate rates is diminished incentives to contain costs. If insureds do not pay the full cost of their coverage, they will have diminished incentives to control that cost through accident prevention and minimizing damages following an accident. The consequence is higher accident rates, more expensive claims, and higher loss costs, which place greater pressure on the market and force prices to increase.

Regulators can potentially assist consumers by increasing the information they have and preventing market abuses by insurers and producers. For example, if an insurer fails to meet its obligation to pay a claim under an insurance contract, the insured can sue the insurer but such action can be costly in terms of time and money. An insurer may have more resources to sustain litigation than the insured. Regulators can help to balance

market and undercut the incumbent insurers.

the relative positions of the insurer and insured by taking enforcement action against the insurer. Similarly, regulators may find it more efficient to simply disallow policy provisions that they believe to provide inadequate or misleading coverage, rather than relying on consumers to determine this for themselves.

Increasing consumer information offers an effective substitute or complement to regulatory activities. Greater information enables consumers to make better insurance decisions, which increases competition among insurers and market efficiency. Regulators can improve consumer information by educating consumers on how to purchase insurance and publishing information on insurers' prices, products and quality of service.

Synopsis of Key Points

1. The public interest theory of regulation provides a foundation for the principles that should govern insurance regulatory policies intended to serve consumers and the general public.
2. Regulation, narrowly defined, is the government restriction of private action to achieve public goals.
3. Regulation is intended to remedy market failures, which represent violations of the conditions for workable competition.
4. Solvency regulation is intended to limit some insurers' tendency to incur excessive financial risk, because of consumers' limited information and difficulty in controlling insurers' actions.
5. Market regulation of insurers' prices, products and trade practices is intended to prevent prices from rising too high (because of insurers' market power) or too low (because of overly aggressive price competition) and other abuses that might arise from consumers' lack of information and unequal bargaining power.
6. Solvency regulation will necessarily restrict market entry and may limit the range of insurers' prices and products, which constitutes a tradeoff with reduced insolvency risk.

7. Regulation can improve market performance if insurers exploit any market power that they are able to acquire. However, competition prevents insurers from acquiring significant market power. Regulation also can distort market forces and hurt efficiency if it suppresses prices below costs.
8. Insurance regulatory institutions have evolved considerably since the first state insurance commissioner was appointed in 1851. All states, the District of Columbia, and the U.S. territories have chief regulatory officials for insurance and agencies that support them.
9. Insurance regulators have broad authority to regulate insurer solvency and protect consumers. At the same time, they must function within a governmental framework, which also affects insurance regulatory policy.
10. There has been tension between the federal government and the states over the regulation of insurance, but the states have retained principal regulatory authority over insurance except in instances where federal law specifically supersedes state law
11. The NAIC plays an important role as a vehicle that individual insurance commissioners use in coordinating their activities and sharing certain resources.

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