

Insurance Regulation: The Need for Policy Reform

Presentation

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Principles for Insurance Regulation

- Role of regulation is to remedy market failures when it can do so efficiently.
- “Market Failures” versus “Market Problems”
- Most economists accept argument that information problems warrant some regulation of insurance.
 - Financial regulation and transparency
 - Some aspects of market conduct
- Efficient policies:
 - Remedy true market failures when feasible.
 - Replicate competitive market outcomes.
 - Encourage market discipline.
 - Weigh benefits vs. costs.

Ideology, Politics & Reality

- Views differ on the “appropriate” scope of regulation and its policies.
- Greater consensus on financial regulatory objectives; differences on standards/methods.
- Insurance market regulation broad in scope & heavily influenced by politics.
 - Prices
 - Product constraints and mandates
 - Marketing, underwriting & claim adjustment
- Current regulatory policies differ substantially from what most economists believe are appropriate.

Current State Framework/Policies

- Each state is the primary solvency regulator for its domiciliary companies with second layer of oversight by other states & NAIC.
- Each state asserts primary regulatory authority for all aspects of market regulation in its jurisdiction.
- Solvency regulation is fairly uniform; market regulation varies significantly among states.
- Many states impose “excessive” constraints & mandates on market practices; policies greatly affected by state politics, circumstances, etc.
- Insurers struggle with both the number of regulators and their idiosyncratic policies.

Financial Regulation

- Current system is rules-based and highly prescriptive.
- This approach is becoming increasingly antiquated and inefficient.
- Strong need to move to a principles-based, prudential system.
- Regulators need to:
 - Use & encourage firm internal risk modeling & enterprise risk management.
 - Eliminate unnecessary rules & restrictions.
 - Pay attention to management competence.
 - Increase reliance on market discipline as regulator.

Price Regulation

- Approximately $\frac{1}{2}$ of the states still impose prior approval requirements for personal lines & workers' compensation insurance rates.
- Price regulation unnecessary in light of highly competitive nature of insurance markets.
- Price regulation is irrelevant at its best and potentially very harmful at its worst.
- Regulation invites political manipulation & can create severe market distortions, e.g., Florida property insurance.
- Deregulated markets have achieved superior performance.

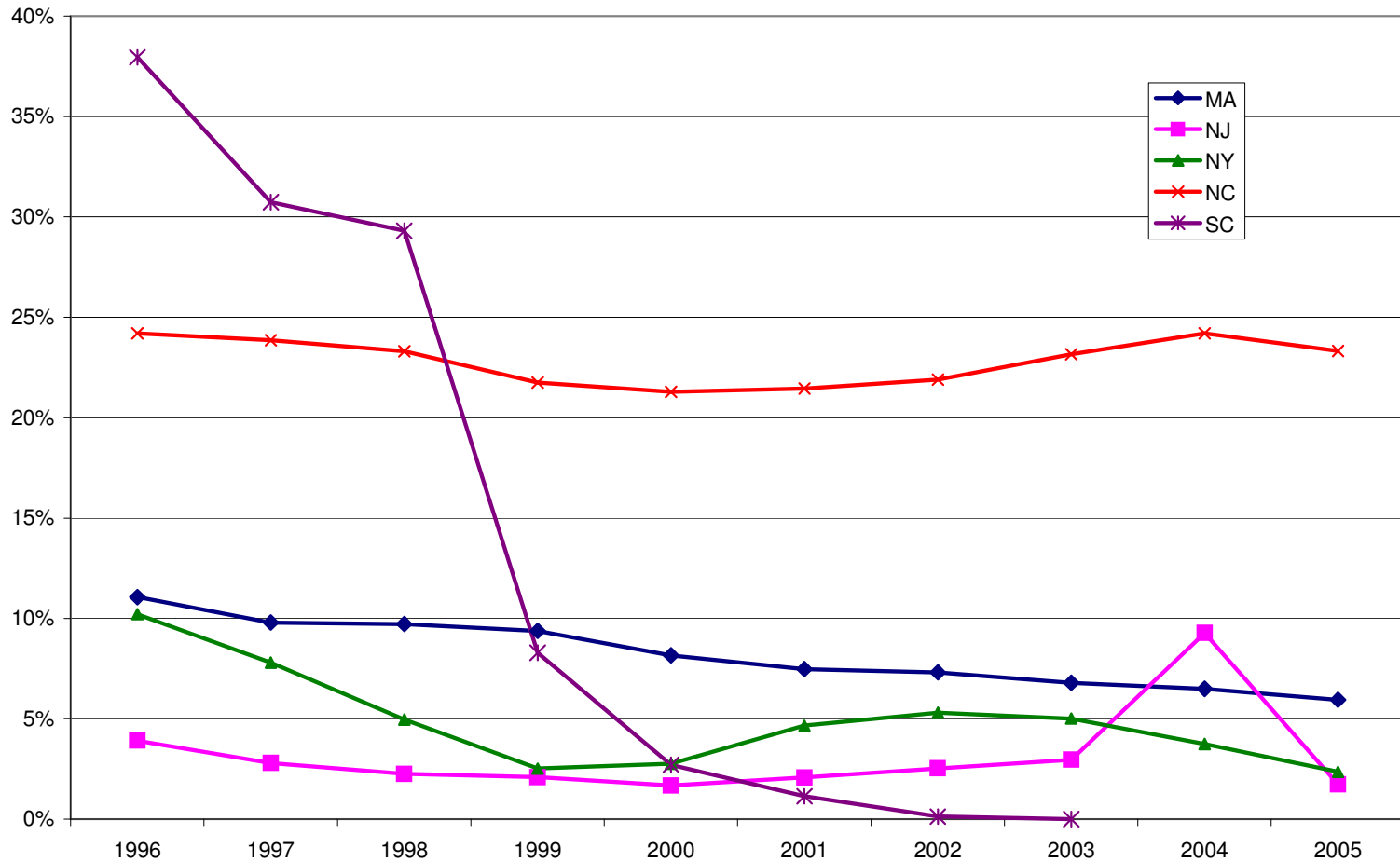
Competitive Markets

| Property-Liability Insurance Market Structure (2006) | | | | | | |
|--|--------------------|--------------------|---------|-----|------------|----------|
| Line | Number of Insurers | Pct. of Sector DPW | CR10(%) | HHI | Since 1997 | |
| | | | | | Entries(%) | Exits(%) |
| Personal Auto | 389 | 33.2% | 64.1% | 651 | 29.4 | 48.9 |
| Commercial Auto | 389 | 6.2% | 44.4% | 272 | 33.4 | 46.2 |
| Homeowners | 438 | 12.3% | 64.2% | 784 | 27.9 | 41.2 |
| Fire & Allied | 544 | 4.2% | 53.7% | 502 | 24.8 | 41.6 |
| Commercial MP | 365 | 7.4% | 49.0% | 318 | 24.1 | 45.6 |
| General Liability | 697 | 12.2% | 57.7% | 595 | 36.8 | 42.8 |
| Medical Malpractice | 225 | 2.5% | 45.8% | 295 | 112.4 | 57.2 |
| Workers' Compensation | 312 | 9.5% | 54.2% | 487 | 32.1 | 48.0 |
| Other | 715 | 20.0% | 43.1% | 255 | 26.2 | 45.8 |
| All Lines Combined | 1,270 | 100.0% | 48.6% | 318 | 43.5 | 43.4 |
| Source: NAIC Data and A.M. Best's Key Rating Guide | | | | | | |

Price Regulation & Residual Markets

- Price regulation + residual market mismanagement can create worst of all possible worlds.

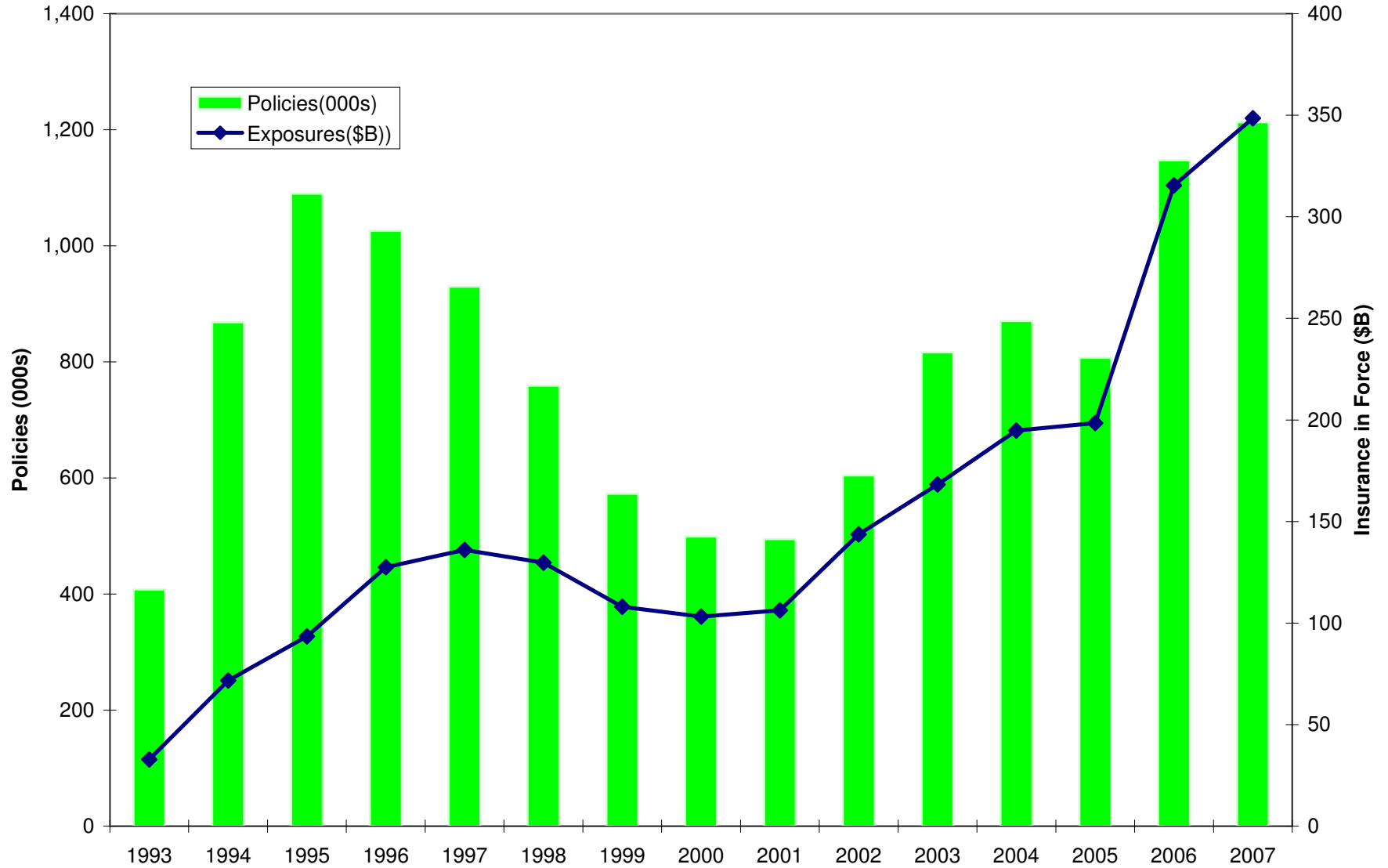
Auto Insurance Residual Market Share: Selected States



Source: AIPSO

The Florida Disaster

FL Property Residual Market



Product Regulation

- Regulatory review of some products necessary.
- Problems with current system:
 - Excessive constraints
 - Mandated coverages/benefits
 - Unnecessary review of commercial insurance policies
 - Tortuous review/approval process
- Current policies impede competition, delay product improvements, increase costs & stifle innovation.
- Regulation should be confined to ensuring certain personal insurance products meet minimum requirements & terms are “relatively” transparent.
- Expedite review and approval process.

Underwriting & Market Practices

- Some regulation of market practices necessary to prevent abuses.
- Problems with current policies:
 - Mandatory offer requirements
 - Constraints on underwriting/pricing criteria
 - Intrusive “market conduct” exams
- More efficient policies would:
 - Maximize insurers’ discretion in underwriting/pricing.
 - Focus on patterns of severe abuse, e.g., fraud, blatant product misrepresentation, failure to pay claims, etc.

Antitrust Policy

- Under current law insurance industry has limited antitrust exemption.
- Over time exemption broadly interpreted but insurers still subject to antitrust actions.
- Beneficial practices exempted:
 - Sharing of loss data and analysis
 - Common policy forms
- Exemption repeal could increase legal uncertainty but might have limited if any real effects.
- Modified exemption could permit essential practices without perception of antitrust immunity.

Prospects for Change

- When & how insurance regulatory framework will change is uncertain.
- Efficient policies should be employed regardless of who is the regulator.
- Full policy reform will be difficult under current state framework.
- Regime change could facilitate broader reform.
- No guaranty that federal regulator would employ efficient policies.