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FOUNDATION FOR AGENCY MANAGEMENT EXCELLENCE

Costs & Benefits of Future Regulatory Options for the U.S. Insurance Industry

An Analytical Framework

Prepared for the Foundation for Agency Management Excellence by

Georgetown Economic Services, LLC and Adam K. Lee (Independent Consultant)

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PROMOTING LEADERSHIP AND EXCELLENCE THROUGH MANAGEMENT EDUCATION, RESEARCH AND TRAINING.

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Established in 1993, FAME was created to achieve the following goals:

- To encourage high standards of excellence and leadership;
- To prepare young managers to meet the leadership challenges of the future; and
- To study management issues and develop a body of research, ensuring that agents and brokers stay on the cutting edge of technology and productivity issues throughout the industry.

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FOREWORD

We would like to express our appreciation to the Foundation for Agency Management Excellence for their patience in providing us with 12 months to complete this study. The time frame allowed us to review thousands of pages of material from dozens of different sources in preparation of this report.

In undertaking this study, we expressly avoided any attempt to find a particular position along the continuum of different ideas and approaches that have been put proposed to date. Instead, we adopted the role of impartial examiner. While we reached certain preliminary and generalized conclusions, we have stopped short of recommending an idealized regulatory structure. Instead, the study is intended to help frame or focus the debate, rather than settle it.

The landscape was considerably different just one year ago when we began the study. There was a talk of an extended hard market in property-casualty lines and uncertainty whether a sufficient number of states would adopt NARAB reciprocity requirements. There was less pressure on state budgets, and hopes that the Gramm-Leach-Bliley Act might better clarify regulatory jurisdictions between federal bank and state insurance regulators. Enron Corporation's market value was nearly $50 billion.

And, most significantly of course, terrorist attacks were not a primary concern. In that connection, we extend our deep condolences to all of those in the industry who were impacted so directly by this tragedy. Even as the industry was coping with its own disproportionate toll, it provided an invaluable stabilizing influence that helped restore confidence that such challenges could be overcome. This is a worthy achievement for which the industry should be given tremendous credit.

We resisted the temptation to continue reshaping our analysis to reflect the latest shift, seismic or otherwise, in the landscape. We recognized that as far and as fast as conditions had changed in just one year, they easily could do so again. Consequently, we thought it more appropriate to maintain our initial stance and focus. While we have incorporated and referred to these major developments as we felt they were pertinent, we have not focused directly on them.

We do feel, however, that one point bears mentioning in this regard. At the outset, we emphasized that, unlike in many past episodes, the current impetus for regulatory change is not being driven by a crisis, but rather by the accelerated evolution of the insurance and entire financial services industry. Consequently, we posit that the current environment may be uniquely conducive to the achievement of regulatory changes long-sought by the industry. While we maintain that premise today, we believe the environment has been transformed significantly by these interim developments, which may have ramifications on the potential for achieving dramatic changes in the near-term.

Ideally, this study will be received as an objective overview of the environment based on sound but not arcane economic principles, as opposed to more partisan, presumptive or theoretical approaches. We hope that it is useful in helping to trigger new ideas, as well as order priorities and set future strategies.

Adam K. Lee

On behalf of
Georgetown Economic Services, LLC

TABLE OF CONTENTS

Executive Summary

The Council is pleased to present an introductory economic study of the regulatory options for oversight of the business of insurance. This study, a project of the Foundation for Agency Management Excellence ("FAME"), was prepared to educate Council members on this important topic. FAME retained Georgetown Economic Services, an independent economics consultant, to provide the analysis. Its publication at this moment could not be more timely as policy makers in Washington are initiating their own investigation into these important questions. The House of Representative's Financial Services Committee will, for example, begin a series of preliminary hearings in June that are designed to bring these issues to the fore.

That the current state-based system of insurance regulation needs repair is beyond question. Duplicative and sometimes conflicting regulatory requirements from state to state often-times make compliance by both insurers and agents and brokers difficult if not impossible, and can lead to confusion and frustration among consumers. Indeed, state regulators themselves have recognized the need for modernization —

> "The Commissioners [of Insurance] are now fully prepared to go before their various legislative committees with recommendations for a system of insurance law which shall be the same in all States — not reciprocal, but identical; not retaliatory, but uniform."

This statement was made by George W. Miller, the New York Insurance Commissioner, in **1871** at the close of the inaugural meeting of the National Association of Insurance Commissioners which he chaired. Unfortunately, as we sit here today — over 130 years later — the full promise of that good intent still has not been realized.

The questions we now face both as an industry and as a country are how best to resolve these problems and how to regulate the business of insurance as we enter the 21st century. This project was not designed to answer that question directly but to develop an objective framework in order to evaluate and compare the various regulatory structure options that are available to ensure a quality regulatory environment going forward. The next step in the process is to analyze the regulatory options available through this framework and apply the lessons learned during the initial phase of the study. We believe, however, that the framework itself and the findings and conclusions on which it is based help to shed light both on the extent of the regulatory problems that currently exist and on the costs and benefits of the potential structural reforms that have been identified to date.

OVERVIEW

The purpose of this study is to develop an objective framework in order to evaluate and compare the costs and benefits of various regulatory structure options available to the industry. The differentiation between the scope of regulation (what is regulated) and the structure of regulation (how/by whom it is regulated) is crucial to this framework.

In the context of this study, the interaction between scope and structure is a critical dynamic and might be seen as a strong rationale for structural change as an impetus toward achieving improvements in the scope of regulation. The existing structure's inherent tendency toward non-uniformity, redundancy and distortions (via externalities) often produces inefficient regulations, whether with respect to developments in emerging areas or reforms in existing areas of oversight.[1] Once implemented, non-uniform regulations tend to perpetuate the scheme that created them — i.e., once state-by-state requirements are adopted, state-by-state monitoring and enforcement usually follows. Consequently, structure becomes a critical influence on those regulations under conditions of change and reform.

The structure of the state regulatory system in an increasingly interstate or even international market makes it prone toward generating externalities.[2] While state-by-state variations in regulatory requirements (i.e., *scope*) are a product of the system's structural weaknesses, they also exacerbate the state system's inherent tendency toward non-uniformity, redundancy, and generating unintended consequences. The generation of negative externalities — when other states accrue a cost without a corresponding benefit as a result of the regulatory actions of another state — is key in this context. While variations in the scope and conduct of regulation often appear to be the root cause of many externalities, in most cases, they are facilitated by the structural limitations of the regulatory scheme.

Certainly, there are compelling and legitimate reasons for maintaining functional and/or geographical elements in the structure of regulation. For example, historical expertise and the endorsement by GLBA are prime reasons for maintaining functional boundaries, while local market familiarity, legal standards, and sunk "investment" costs are prime reasons for maintaining state oversight. Nevertheless, as the insurance industry becomes less functionally distinct and more international in breadth, interim and incremental improvements along traditional functional and geographic lines may prove to be only a temporary panacea.

The perspective from which regulators approach their oversight responsibilities can have an important bearing on the relative efficiency and effectiveness of any given combination of alternatives and options. The two basic variations in regulatory perspective are ***prescriptive approaches*** and ***prudential approaches***. The prescriptive approach characterizes the current U.S. system of regulation and utilizes a detailed set of generally *ex-ante* restrictions or requirements on regulated entities with regard to each aspect of their operations. The prudential approach, more evident in European regulation, provides greater overall flexibility and fewer specific restrictions, but relies on greater *ex-post* emphasis in oversight, such as more intensive regulatory monitoring and greater discretion for intervention by regulatory authorities.

GENERAL CONSIDERATIONS

- One of the primary contributors to the inefficiency of regulation, whether in terms of its excessive

1 At the same time, these characteristics of the state-based structure provide certain advantages. Non-uniformity is not a fault by itself if it is founded on legitimate economic or other (localized) considerations. Moreover, while redundancy rarely constitutes the most *efficient* approach, it can lead to more *effective* regulation since the collective activities of multiple regulators have the potential to produce broader and better-rounded solutions. The key point is whether these advantages represent a reasonable and necessary trade-off for the cost of the inefficiencies and distortions that tend to be characteristic of this structure.

2 Externalities are costs or benefits that arise from an economic transaction which are borne by parties not involved in the transaction and results from the failure of the transaction price to account for the externality. See Spulber (1989) at 46. Externalities involve the unfair or inadvertent shifting of costs and benefits such that a single event gives rise to both positive externalities (to the recipient of the benefit) and negative externalities (to the bearer of the cost). The immediate discussion is focused on negative externalities and omits consideration of the corresponding positive externalities that also are generated.

costs or capacity to introduce distortions into the market, is its tendency to be oriented toward outcomes in the short-run, rather than processes in the long-run. This is understandable since outcomes are more tangible and obvious than processes, and ultimately, regulators are more directly responsible for the outcomes, rather than the method or efficiency with which those outcomes are achieved.

- Indirect and unintended effects of regulation often are adverse and undermine the benefits accruing from the achievement of the regulatory goals. By extension, efforts to reform and modernize regulation will likely alter the incidence (impact) of those costs and benefits, as well as generate their own indirect and unintended effects.

- Regulations that interfere with incentives for loss control or with the relationship between expected loss costs and premium levels go far beyond the basic rationale for regulation — to correct or minimize market failures. In fact, such regulations tend to exacerbate, if not promote, market failures, and increase the overall cost of risk to the overall economy.

- The optimal regulatory structure must meaningfully address the costs and distortions to the market directly related to regulation.

- At the very minimum, alternative regulatory structures must demonstrate adequate performance on the core regulatory objectives of solvency and consumer protection. However, most of the potential efficiency gains will come from improved performance in the secondary or peripheral areas of regulation (e.g., licensing and rate and form approval) ideally by reducing the scope of regulation (deregulation) rather than by reengineering existing processes.

- While agents and brokers may be affected uniquely or discretely by regulation vis-à-vis other segments of the industry, the regulatory structure that best serves the industry as a whole likely will prove optimal for agents and brokers as well. While agents and brokers play a key role in the market by helping to mediate and minimize conflicts between insurers and consumers, as well as reduce information constraints on both sides of insurance transactions, they are neither designed nor equipped to undertake direct regulatory responsibilities for either insurers or consumers. Transferring such responsibilities to agents and brokers will decrease the effectiveness and the efficiency of regulation.

- The market has the inherent capabilities of performing its functions much more efficiently and competently if permitted, while still remaining within the bounds of effective regulation.

- Deregulation often is preferable to lesser reforms, even though the later may constitute a necessary interim step

POLICY CONSIDERATIONS

- Both regulators and politicians have demonstrated increased awareness that unnecessary regulatory distortions, frictions and costs have become less tolerable to the industry given the competitive and fast-changing market conditions in which it is operating. These factors have been transformed from costs and inconveniences to potential competitive disadvantages that threaten the long-term health and performance of the industry.

- An increasing proportion of insurance transactions is migrating beyond the reach and direct control of state regulators to alternative markets and other non-traditional risk-financing mechanisms, with little evidence of adverse ramifications. This shift has important implications regarding the cost/benefit profile of regulation, whether information constraints still constitute a legitimate market failure, whether such constraints can be overcome by the industry and consumers, and whether the overall system faces greater or lesser risk as a result of this migration.

- The business environment is being transformed by financial services convergence and modernization, e-commerce and globalization, all of which have accelerated and sharpened competitive forces. Under these conditions, the costs of regulation are magnified, particularly given their potential to produce significant disadvantages vis-à-vis new domestic and foreign competitors (or products) that are not subject to the same regulatory constraints. While this applies to the costs of even minimally necessary regulation, it is most relevant when regulatory constraints begin to impose significant burdens and inefficiencies without attendant benefits or even suitable underlying rationales.

- The tendency of insurance regulations to produce distortions and other unintended effects, regardless of the structure in which they are administered, can generally be attributed to two fundamental causes — the undermining of competitive market forces that generate incentives for loss control and the interference with the normal relationship between premium levels and expected loss costs.

- Efficiency concerns are critically important to the industry, since they affect its direct compliance costs. Under such circumstances, the efficient conduct of unnecessary or excessive regulation becomes the next best alternative to more effective regulation generally, in order to minimize both its direct and indirect costs. The critical point is that the focus on achieving the next best alternative — making unnecessary regulation less costly and more efficient — may come at the expense of the best alternative — eliminating such regulation altogether. To a certain extent, efforts focused on improving the conduct of, or otherwise curbing, ineffective and unnecessary regulation, while perhaps more achievable than seeking its complete elimination, inadvertently tend to validate the necessity of such regulation in the first place. Nevertheless, this focus is understandable given how firmly entrenched and resistant to change many of these regulatory processes have become.

STRUCTURAL CONSIDERATIONS

- The limitations of traditional regulatory structures under current competitive conditions have tended to increase jurisdictional and functional disputes among the regulating agencies and other authorities as they compete to either protect their turf or try to reestablish clear dividing lines among their responsibilities. In addition, however, regulating agencies and authorities are recognizing the need for a more flexible and holistic approach to regulating financial services that relies more on cooperation, information exchange and shared responsibility. Regardless, the continuing trend toward convergence in financial services has shifted the burden of adjustment to the regulators.

- As the insurance industry becomes less functionally distinct and more national and international in breadth, interim and incremental improvements in regulation along traditional functional and geographic lines may prove to be only temporarily palliative. Even worse, limited reforms may tend to further entrench structures and practices that may not be suitable or optimal for the industry in its new competitive environment.

- Two of the primary rationales for maintaining the state regulatory structure of insurance are its abilities to tailor products and services to unique state market conditions and requirements, and to offset consumer information problems and deficiencies. These advantages are offset by inefficiencies related to redundancies and diseconomies of scale that are characteristic of decentralized authority.

- The state-based structure's primary weakness may be its susceptibility toward generating negative externalities. Consequently, assessments of alternative structures must address this issue and the extent to which this particular susceptibility can be reduced or minimized. A related problem concerns geographical limitations within the state structure, which often require that regulatory determinations be made on a state-by-state basis. The fundamental question is whether such state-specific analyses are meaningful in an increasingly national and international market.

- Congress has focused repeatedly on the industry's solvency problems, citing numerous and persistent examples of ineffective solvency oversight by state regulators as prime factors. State regulators have been quick to respond by undertaking reforms and other actions to avert direct federal involvement. Nevertheless, past insolvencies have raised the question of whether regulators can identify company-specific problems, such as aggressive pricing and the understatement of reserves, on a reliable and sufficiently early basis. Corollary issues include concerns regarding the regulatory reach and expertise of regulators with respect to foreign markets and insurers, nontraditional markets and products and reinsurers (who play a relatively low profile but key role in market functioning).

- All of the major reforms accomplished under the existing state structure have occurred only in response to major external threats of federal intervention or wholesale dislocations in the regulated markets. Based on these precedents, there is no assurance that the state-based system will enact meaningful further reforms absent a significant level of continuing threat and pressure. The experience with NARAB and producer licensing to date supports this conclusion.

- The imposition of minimum standards within the existing state system could potentially improve uniformity. There is considerable evidence, however, that when these standards are set relatively low or when they continue to permit significant state discretion and variation, much of the potential benefits are undermined. There also is increasing evidence that the lack of uniformity among the states acts as a shaky foundation for improvements in reciprocity.

- Regardless of whether the states undertake significant further reforms, the inexorable trend seems to lead away from continued state regulation. If states fail to undertake significant reforms, the state system will become increasingly unsuitable to the current environment and generate tremendous pressure for wholesale change. If, on the other hand, the states undertake significant reforms and achieve a greater degree of uniformity, reciprocity and comity, those reforms will help set the stage for a further move toward federal regulation. Nonetheless, the state structure will remain under pressure whether the states move ahead or obfuscate.

ALTERNATIVE/FUTURE STRUCTURAL CONSIDERATIONS

- The optimal regulatory structure must meaningfully address the most problematic regulatory areas identified — primarily company and producer licensing as well as rate, risk classification and form regulation — even though these are less critical areas than solvency and consumer protection. Regulatory conduct in these areas is generally excessive, inefficient and often ineffective, if not harmful, to market functioning. In this context, deregulation likely is preferable to lesser reforms, even though the latter may constitute a necessary interim step.

- Convincing support for one structural alternative or another must be characterized by an improvement in regulatory effectiveness as a threshold matter, particularly given the growing indications that the current structure may lack the capacity to manage its functions adequately, particularly under adverse business conditions.

- In evaluating alternative regulatory structures, the industry is advised to give greater weight to alternatives that facilitate deregulation rather than those that facilitate specific changes in existing regulations. While the state structure has shown it can achieve deregulation, it tends to occur on a non-uniform and piecemeal basis. Moreover, such efforts have been most successful under the threat of federal intervention.

- Universal options and regulatory perspectives — the net benefits of each of the regulatory alternatives (including maintaining the existing system) would tend to be maximized if the alternative incorporated certain universal options or approaches that are not specific to each structure. These include broader versus narrower application of changes and participation by regulating entities, the degree of self-certification or self-regulation allowed, the reorganization of regulation along distinct product or consumer segments and the adoption of a prescriptive versus prudential approaches to regulation more generally.

- Any alternative that reduces the number of potential jurisdictions (e.g., interstate compact, mandatory or optional federal regulation in any form, or financial services super-regulator) has the potential to achieve rapid or wholesale deregulation, as well as improvements in uniformity (or even make uniformity cease to be an issue).

- The Gramm-Leach-Bliley Act, while offering significant near-term regulatory improvements, also has set the industry upon a potentially conflicting course in the longer-term. While the Act simply synthesizes and embodies a number of forces already at work, it likely will trigger further changes in the financial services industry as a whole that will continue to strain the regulatory structure. The Act encourages less functional differentiation within the industry while maintaining functionally distinct oversight. Without further changes, maintaining functional regulation as the industry continues to converge, integrate and globalize will produce many of the same problems as maintaining state regulation in an increasingly interstate and even international market.

I Introduction

The purpose of this study is to develop an objective framework in order to evaluate and compare the various regulatory structure options available to the industry. Critical to this framework is differentiating between the *scope* of regulation (what is regulated) and the *structure* of regulation (how/by whom it is regulated). While the framework seeks to rely on empirical information on the explicit costs and benefits of each alternative to the extent possible, it recognizes the severe limitations in the availability of such information.

Nevertheless, the framework suggests that evaluations of alternative regulatory structures require a holistic approach that begins with the fundamental premise that regulation imposes costs upon the market that should be justified by its benefits. This approach forces consideration away from outcomes (e.g., solvency and consumer protection) and toward overall market efficiency and functioning (i.e., the overall cost of risk).[3]

The framework also suggests that the indirect and unintended effects of regulation often are adverse and undermine the benefits accruing from the achievement of stated regulatory goals. By extension, efforts to reform and modernize regulation will likely alter the *incidence* of those costs and benefits, as well as generate their own indirect and unintended effects.

Importantly, the study does not focus on the regulations themselves or how they might be improved, except to test them generally against typical economic rationales for regulation and assess their effects on overall market efficiency. In accordance with these tests, however, the study identifies several regulatory *areas* that lack adequate justification from the standpoint that they are economically unnecessary, impose excessive costs, and/or introduce other distortions into the market.[4] One of the study's key conclusions is that the optimal regulatory structure must meaningfully address these problematic regulatory areas, and that deregulation often is preferable to lesser reforms, even though the latter may constitute a necessary interim step.

There is little debate that the rules and regulations must be modernized, streamlined and made more flexible, as industry dynamics and market growth continue to strain, as well as be constrained by, the limiting tendencies of the existing, primarily state-based structure. This study takes a more generic viewpoint in its focus on regulatory efficiency and accountability, as well as business facilitation and competition issues. Thus, the study consciously avoids consideration of political realities and the views of interest groups, or debates regarding the efficiency of one type of regulation over another within a given regulatory area.

The main points of emphasis and unique considerations of the study are summarized as follows:

- Rather than rationalizing a particular regulatory solution, the study analyzes where inefficiencies and distortions are evident under the current structure, and how regulatory structure (as opposed

3 One of the primary contributors to the inefficiency of regulation, whether in terms of its excessive costs or capacity to introduce distortions into the market, is its tendency to be oriented toward *outcomes* in the short-run, rather than processes in the long-run. This is understandable since outcomes are more tangible and obvious than *processes*, and, ultimately, regulators are more directly responsible for the outcomes, rather than the method or efficiency with which those outcomes are achieved.

4 Regulatory *areas* and specific types of regulations are distinct. For example, price or rate regulation constitutes a regulatory area, whereas competitive rating or prior approval laws constitute specific regulations within that area. Similarly, entry qualifications and barriers constitute a regulatory area, whereas bond requirements and countersignature laws constitute specific regulations within that area.

to regulatory scope or conduct) may either contribute to, or potentially resolve, these inefficiencies and distortions.

- Since the study focuses on regulatory structure, it takes as a given that the specific rules and regulations could be improved and instead seeks to provide a starting point for determining how structure may impact the achievement of desirable changes (including deregulation) in the rules and regulations.

- By avoiding conclusions regarding a particular solution, the study circumvents many of the complicating factors inherent in the proposals offered and discussed to date by other interested parties. These factors involve complex political and legal considerations, state tax revenues, regulatory bureaucracy, and funding issues that tend to obscure the purely economic foundations or merit of such proposals. Thus, rather than evaluate possible structures subject to comparatively indeterminate political and legal considerations, this phase of the study attempts to outline a more efficient *manner* of regulation based on typical economic rationales.

- While this study was prepared on behalf of the Foundation for Agency Management Excellence ("FAME"), its completion and conclusions were developed independently and with no guidance from any interest group. Consequently, the views expressed in this report are those of the authors and do not necessarily reflect the views of FAME.

II Regulatory Scope Versus Structure

A. UNDERLYING MARKET DYNAMICS

The possible regulatory alternatives to the existing, primarily state-based structure are numerous and differ greatly. Moreover, each alternative has a number of variations that complicates their evaluation and comparison. While all of the alternatives and options share the same fundamental goals, the sheer number of interrelationships and competing interests among the market participants, as well as among the regulations themselves, make clear that these basic goals can be produced in a multitude of ways and with widely varying degrees of success. How that success is judged is dependent not only on one's perspective, but also on how reform changes the overall costs and benefits of regulation, as well as the incidence of those costs and benefits.

While reform is expected to yield improvements for the market overall, the effects on the various segments and components of the market likely will be disparate, creating opportunities for some and handicaps for others. In addition, the *unintended and indirect* effects of reform and modernization have the potential to undermine or even overwhelm the *intended and direct* effects, such that achieving limited improvements in one area could cause more significant problems in other areas.

It is important to recognize, therefore, that while some alternatives and options likely will be more effective than others, pinpointing the optimal or ideal solution, or even combination of solutions, is considerably more difficult. As has been recognized, it is perhaps more important at this juncture to systematically assess the alternatives as the industry engages in the evolutionary process of modernizing its regulatory scheme.

Before turning to the specific regulatory alternatives, it is important to recognize two fundamental points. First, the insurance market is competitively structured and serving the basic needs of its participants, and regulation has contributed in part to this performance. While market functioning certainly can be improved, there is no immediate crisis driving the impetus for change as there has been in the past, although that possibility suddenly looms large following the industry's unprecedented experience in 2001. Crisis or not, it is clear that certain aspects of regulation have interfered with and distorted the market and has undermined its ability to carry out its core functions. The salient point is that the market has the inherent capabilities of performing its functions much more efficiently and competently if permitted, while still remaining within the bounds of effective regulation.

Second, the regulation of the insurance market is not accurately characterized as a monolith of state oversight and control. While state regulation forms the backbone, there are many other aspects incorporating federal regulation, interstate compacts, international, national and voluntary standards, self-regulation, alternative markets and last, but certainly not least, the natural forces of competition. In short, the industry and its regulation are constantly interacting and evolving, with each playing a direct role in influencing and shaping the other. Indeed, the accelerated modernization effort now underway is a direct product of the industry's own development and evolution, which is believed by many to have outpaced the ability of the existing regulatory structure to keep pace.

Evaluations of alternative regulatory options encompass both scope/conduct and structure. *Scope/conduct* refers to the activities subject to regulation and how regulatory requirements are governed by the relevant authorities. *Structure* refers to who regulates the activities and establishes the basis for jurisdiction and enforcement. In order to make fair comparisons, the scope/conduct of regulation must be assumed the same for each alternative under evaluation. By starting with this assumption, the contribution that each alternative structure may provide can be assessed more discretely.

B. THE SCOPE/CONDUCT OF REGULATION

Under the current regulatory scheme, the scope of regulation can be organized into several broad categories, as follows:

Corporate structure and authority to conduct business — includes company and agent/broker licensing, agent appointments, continuing education requirements, change of control, affiliations and related party transactions, and company structure (especially demutualization and establishment of financial services holding companies under the Gramm-Leach-Bliley Act ("GLBA")).

Market conduct and operational trade practices — encompasses all points of interaction between underwriters/agents and brokers and their customers, including market conduct examinations to assess compliance with regulations and guidelines on advertising and other marketing activities, sales activities, complaint handling, underwriting and claims handling, and privacy protections.

Product approval, pricing and risk classification — includes review of policy or contract forms and pricing, minimum disclosures, plan structure and administration, and underwriting standards.

Financial regulation, taxation, and solvency monitoring — includes minimum capital and reserving requirements, guaranty fund assessments, rehabilitation and receivership, portfolio restrictions and valuation, accounting standards, disclosure and reporting, and state and federal taxation.

The scope/conduct of regulation continues to undergo significant changes, especially agent and broker licensing, rate and form filings/approvals, and the more general deregulation of commercial lines. Changes in the underlying regulatory structure will likely broaden and accelerate changes in the scope of regulation, though it is not clear exactly how that might happen or who might benefit or suffer. Many proposals for change presume that the desired changes in the regulatory structure will produce the desired changes in the regulatory scope, primarily by altering or even eliminating regulations deemed to be unnecessary or ineffective. This study, however, limits its focus to the extent to which changes in the regulatory structure might lead to improvements in the *administration* of the existing scope of regulations, as well as fostering an *environment* more conducive to achieving future changes in scope that are more in accordance with standard economic rationales.

C. THE STRUCTURE OF REGULATION

1. BACKGROUND

In the debate over the industry's regulation, numerous problems with the existing, primarily state-based system have been identified. Most of these problems center on the *efficiency* as opposed to the *effectiveness* of the state-based structure, although concerns regarding the latter have dominated at times. In this context, *efficiency* refers to the presence or absence of regulatory frictions, the primary of which are compliance costs and the speed of regulatory responses, as well as market distortions. *Effectiveness* refers to the achievement of regulatory goals, the primary of which are industry solvency and consumer protection.

Over the last ten years, the property/casualty industry has endured a relatively tumultuous operating environment, posting both record profits and record losses within that time frame, although it has so far avoided the market problems that arose in the late 1980s and early 1990s. The resulting Congressional attention and significant reform efforts at that time helped improve the *effectiveness* of regulation. While there have been occasional major insolvencies, fraud and other market problems in the interim, the industry avoided the systemic crises that plagued the other financial services sectors during this period.[5]

As a result, the balance of regulatory concern has tilted more in favor of overall market functioning and the industry's ability to respond to new competitive challenges. Both regulators and politicians have demonstrated increased awareness of the fact that unnecessary regulatory distortions, frictions and costs have become less tolerable to the industry given the competitive and fast-changing market conditions in which it is operating. Indeed, the Gramm-Leach-Bliley Act, along with the series of important shifts in financial services regulation that preceded it, is a product of that awareness. While the Act reflects a culmination of change in one sense, it will spur further changes in shaping all segments of the financial services industry in an increasingly interrelated manner in the future.

The market conditions under which state regulatory reforms and financial services modernization were inaugurated, however, have deteriorated dramatically in recent years. As detailed further in Section V, the property/casualty segment of the industry has endured a sharply fluctuating operating environment over the last decade, punctuated by recurring setbacks. On top of extended soft market conditions, the segment has suffered persistent underwriting losses in every year of the last decade, while repeatedly sustaining unprecedented catastrophe losses. These developments have put tremendous pressure on the financial condition of insurers and reinsurers in this segment.

These unsustainable trends deteriorated even further in 2001 following the disastrous losses due to the terrorist attacks, the failure of Enron Corporation and a surge in toxic mold claims, culminating in the segment's *first-ever annual net loss*. While the industry has weathered these difficulties to date, their full impact has yet to be felt.[6] The industry remains vulnerable to further loss shocks, particularly as reinsurance capacity has been withdrawn, leaving both insurers and consumers to bear potentially hazardous risks they would normally cede.[7] The industry has responded by accelerating rate increases and tightening underwriting standards, but it still faces substantial operating risk from continuing underwriting and market share losses, an absence of capital gains, and a reduction in investment income.

There is evidence that regulatory constraints are partly to blame for the segment's financial woes. Not coincidentally, the segment's worst performing lines — personal and commercial auto liability, medial malpractice and workers' compensation — are the most heavily regulated. Moreover, the segment's overall poor performance reflects a sharp increase in competition, particularly from new entrants and offshore capacity that incumbent insurers are struggling to counter within the bounds of traditional regulated products and markets. Finally, as noted above, the most serious operating risks faced by insurers in the near-term may be regulatory constraints on their ability to exclude or limit terrorism risks in the absence of reinsurance capacity.[8]

The emergence of incalculable new risks within an already difficult operating environment does not portend well for the industry.[9] Current operating conditions are beginning to draw comparisons to the

5 In particular, the banking sector's savings and loan crisis and the Federal Reserve-engineered bailout of Long Term Capital Management within the securities sector are prominent examples in this regard. More recently, the securities sector has drawn increased scrutiny and criticism following the bankruptcy of Enron Corporation, the largest corporate failure in United States history, and the contributing role that accounting firms and securities analysts may have played. The insurance industry's relative performance in a period of often skyrocketing cost inflation (especially for medical costs) and unforeseen claims frequency and severity (asbestos, mold, terrorism and D&O cover) stand in contrast.

6 See ISO (2002). ISO estimates that less than half of the segment's total net underwriting loss due to the terrorist attacks was recognized in 2001. Thus, results in 2002 and beyond will continue to be depressed by the recognition of the balance of these claims as they are administered, in addition to new losses that may be experienced.

7 See GAO (2002) at 5-7, 16-17.

8 IBID.

9 Examples of the numerous prevailing loss risks besides terrorist attacks currently faced by property/casualty insurers include environmental liabilities (asbestos and toxic mold), natural and industrial catastrophes (hurricanes, storms and accidents), computers and business interruption (viruses), employee benefits (new mandatory coverages), corporate governance (bankruptcy, fraud, and D&O liabilities), and political risks (Argentina, Venezuela and the Middle East).

market crisis of the mid-1980s due to the combined forces of capital and capacity depletion, along with potential claims several orders of magnitude greater than resulted from Hurricane Andrew in 1992.[10] Just as that catastrophe caused a sharp spike in insolvencies and guaranty fund assessments, the industry once again may be headed toward a similar experience.[11] Thus, while the reform and modernization effort began under relatively stable market conditions with an eye toward incrementally improving efficiency and industry performance, now the effort has taken on a much more vital role in protecting market confidence and stability, as well as insurer survival.

Against this backdrop, convincing support for one structural alternative or another must be characterized by an improvement in regulatory effectiveness as a threshold matter, particularly given the growing indications that the current structure simply may not be able to manage its functions adequately under adverse business conditions. Despite these pressures and complexities, however, many proposals advocating fundamental structural changes are premised on a relatively seamless and incremental evolution from the existing structure wherein the effectiveness of regulation is never threatened, but emerges stronger and more flexible from the outset. While this outcome is ideal, such broad and fundamental changes in structure have the potential to introduce strains, dislocations and many unintended consequences that could offset the imputed benefits of such changes. These risks must be weighed against the potential continuing problems and limitations that maintenance of the existing state structure likely will produce, as evident in the industry's current operating and financial performance.

2. BASIS FOR STRUCTURE

Regulatory structure is dictated by the basis of compliance and enforcement activities. There are generally three types pertinent to financial services firms:

By entity or charter — "what they are" — the nominal classification of the company determines by whom it is regulated. Companies chartered as insurance companies are regulated by insurance regulators (potentially including their non-insurance activities). Companies classified differently are regulated separately.

By function — "what they do" — the specific and/or primary activities in which a company is engaged determines by whom it is regulated, regardless of its type and/or location. All companies selling insurance products are regulated by insurance regulators, at least in connection with their insurance activities.

By territory/geography — "where they are" — the location of the company, usually in conjunction with its entity/charter and/or function, determines by whom it is regulated, particularly in terms of legal jurisdiction. Companies located or operating in a given locale are regulated by the regulators of that corresponding locale, whether or not further differentiated by charter or function.

These three bases are deceptively simple, as is evident when they are applied to financial services firms that are increasingly doing more than one thing in more than one place, often with similar products that make clear distinctions difficult to find. Innovations, both product and technological, as well as intensifying competition are leading to a convergence in the financial services industry and acceleration in its evolution that are straining traditional regulatory structures. Pertinent examples include the emergence of the internet as an automated and adjunct market to traditional direct contact markets, customer service

10 See Pilla (2002).

11 Again, the full impact of the terrorist attacks and related losses on market solvency has yet to be felt. Even before the terrorist attacks, however, the number of property/casualty insurer insolvencies increased from 7 in 1999 to 31 in 2000. In 2001, a number of large multi-state insolvencies occurred (Credit General, HIH America, United Capital, Superior National, Frontier Pacific and Reliance), of which Reliance is expected to be the costliest insurance insolvency in history. At the same time, more than 20 companies were downgraded by Standard & Poor's and more than 30 placed on "credit watch" with negative implications in 2001. See KPMG (2002); National Council of Insurance Guaranty Funds (NCIGF).

functions that may be encroaching upon advisement and selling functions, and the growing irrelevance of traditional product definitions distinguishing financial products and services that have increasingly become interchangeable with each other.

There have been two primary consequences of the limitations of traditional regulatory structures under current competitive conditions. On the negative side, jurisdictional and functional disputes among the regulating agencies and other authorities have increased as they compete to either protect their turf or try to reestablish clear dividing lines among their responsibilities. These disputes tend to increase regulatory frictions without benefiting either the industry or consumers and are contrary to market dynamics.[12] On the positive side, however, regulating agencies and authorities are recognizing the need for a more flexible and holistic approach to regulating financial services that relies more on cooperation, information exchange and shared responsibility. While these developments are only beginning to be achieved and will encounter setbacks, they are important because they implicitly acknowledge the imprudence of championing one sector of the industry over another as counter to the interests of the industry as a whole. Despite long-standing attempts by regulatory bodies to maintain traditional distinctions in the financial services industry, momentum is clearly now on the side of convergence and that has placed the burden of adjustment on the regulators.

These developments are driving the calls for fundamental changes in the regulation of the insurance industry. Its primarily state-based structure stands in contrast to the banking and securities segments of the financial services industry, whose regulation is much more federally-based. Consequently, some interest groups support a transition toward greater federal involvement led by proposals for optional federal chartering patterned after bank regulation.[13]

If state regulation as currently configured is deemed incapable of efficiently and effectively operating within the industry's new competitive environment, the pertinent issue is not whether a given alternative structure may be more adept at doing so.[14] The proper focus identifies the alternative that most fully resolves the market failures and regulatory frictions that the industry faces given its environment and own evolution, while minimizing the potential indirect and unintended effects that may result from adopting this structure. Moreover, the achievement of improvements under an alternative structure should be accorded comparable weight with the avoidance of indirect and unintended effects, which have significant potential to be even greater in magnitude.

Despite the obvious importance of regulatory structure, structure by itself can only make a secondary contribution to the efficiency and effectiveness of regulation. The rules and regulations themselves generally have greater implications to the industry than the structure under which they are specified, interpreted and enforced. Under any regulatory structure, good rules and regulations — those that are specified clearly, are well understood and which limit arbitrary discretion of regulators — tend to trump poor rules and regulations under the optimal regulatory structure. Nevertheless, under conditions of

12 Jurisdictional turf battles represent a hidden and particularly invidious regulatory cost to the extent that they siphon limited resources away from actual oversight and/or compliance activities. A recent example is the dispute between the Office of the Comptroller of the Currency and West Virginia regarding the preemption under GLBA of certain consumer protections in the State's law governing the solicitation and sale of insurance products. Such disputes are particularly relevant to proposals for alternative regulatory structures that seek either to complement or partially replace the existing primarily state-based structure, since the likelihood of jurisdictional disputes increases as the number of distinct regulating entities grows. Nevertheless, many of these proposals tend to focus on the benefits of competition between regulators without corresponding emphasis on its potential costs.

13 Two pieces of legislation along these lines already have been introduced. The National Insurance Chartering and Supervision Act was introduced by Senator Charles Schumer in December 2001, while the Insurance Industry Modernization and Consumer Protection Act (H.R. 3766) was introduced by Representative John LaFalce in February 2002. Both measures would create a national insurance regulator within the Department of Treasury.

14 To a significant extent, such evaluations are prone to bias against the standing structure, since it is the only one that can be evaluated concretely based on actual historical experience. Consequently, all of the perceived faults of the standing system are easily highlighted and demonstrable. In contrast, proposed alternatives tend to be outlined in more idealized form, often with their speculative benefits highlighted, while their speculative costs and distortions (including transitional costs and unforeseen ramifications) discounted or even omitted. Nevertheless, since the benefits and costs of proposed alternatives can neither be confirmed nor denied concretely, their comparatively subjective/positive assessments usually are accorded similar weight to the more objective/negative assessments of the standing structure. This understandable tendency promotes conclusions or perspectives that any alternative marks an improvement over the existing structure.

change and reform, structure becomes more critical since it can be a key determinant of how rules and regulations are changed going forward.[15]

In the context of this study, therefore, the interaction between scope and structure is a critical dynamic and might be seen as a strong rationale for structural change as an impetus toward achieving improvements in the scope of regulation. The existing structure's inherent tendency toward non-uniformity, redundancy and distortions (via externalities) often produces inefficient regulations, whether with respect to developments in emerging areas or reforms in existing areas of oversight.[16] Once implemented, non-uniform regulations tend to perpetuate the scheme that created them — i.e., once state-by-state requirements are adopted, state-by-state monitoring and enforcement usually follows. Consequently, structure becomes a critical influence on those regulations under conditions of change and reform.

Certainly, there are compelling and legitimate reasons for maintaining functional and/or geographical elements in the structure of regulation. For example, historical expertise and the endorsement by GLBA are prime reasons for maintaining functional boundaries, while local market familiarity, legal standards, and sunk "investment" costs are prime reasons for maintaining state oversight. Nevertheless, as the insurance industry becomes less functionally distinct and more international in breadth, interim and incremental improvements along traditional functional and geographic lines may prove to be only temporarily palliative.

The list of potential regulatory solutions provided in the next section includes several ideas that have not received as much attention, and, for that reason alone (as opposed to any core unsuitability), are unlikely to be supported. These ideas include increasing domiciliary-based regulation with automatic reciprocity, the use of interstate compacts, the establishment of a single-body financial services super-regulator, greater employment of self-regulation, and the reorganization of existing regulators according to regulatory goals as opposed to regulatory functions.

15 See Grace and Klein (1999) at 42-43.

16 At the same time, these characteristics of the state-based structure provide certain advantages. Non-uniformity is not a fault by itself if it is founded on legitimate economic or other (localized) considerations. Moreover, while redundancy rarely constitutes the most *efficient* approach, it can lead to more *effective* regulation since the collective activities of multiple regulators have the potential to produce broader and better-rounded solutions. The key point is whether these advantages represent a reasonable and necessary trade-off for the cost of the inefficiencies and distortions that tend to be characteristic of this structure.

III Alternative Regulatory Structures/ Conduct Options

While the regulatory alternatives under consideration differ widely, they all tend to share a number of common goals, as follows:

- Increasing efficiency through uniformity and reduced redundancy;
- Restoring a more free-functioning market (i.e., greater competitive market regulation);
- Increasing transparency and feedback regarding enforcement and compliance;
- Increasing regulatory accountability and flexibility (i.e., reducing arbitrary discretion);
- Improving regulatory expertise;
- Reducing jurisdictional gaps and conflicts;
- Adapting to the convergence of financial services segments;
- Facilitating globalization of insurance markets; and,
- Retaining performance on oversight of solvency and consumer protections.

A. STATE STRUCTURES

1. *No change* to existing system;
2. Improvements to existing system without federal involvement:
   a. *empowerment of the National Association of Insurance Commissioners ("NAIC")* to mandate certain measures designed to achieve a minimum level of uniformity related to both compliance and enforcement and move away from voluntary participation and adoption by the states (e.g., broadening of *accreditation* beyond solvency oversight);
   b. reduce redundancy through measures focused on centering regulation in a company's *domiciliary state* and providing for *automatic reciprocity* (similar to the European Union structure);[17]
   c. establishment of minimum or explicit *national standards* (e.g., by NAIC, with or without industry and consumer involvement), leaving enforcement responsibility to the states; and,
   d. use of *interstate compacts* to regionalize and reduce the number of regulatory jurisdictions while maintaining some degree of individual state discretion and local control.

B. COMBINED STATE/FEDERAL STRUCTURES

1. *Optional federal charter* — creates new federal regulator that would coexist with existing state regulators but have preemptive powers in specified areas of overlap or conflict; federal chartering left to the discretion of regulated companies; specific lines and activities subject to the charter may vary;

17 See Skipper, Jr. and Klein (1999) at 19-20.

2. *Shared state/federal model* — regulatory responsibilities divided among state and federal authorities (similar to the Canadian structure);[18]
3. Establishment of *limited national standards* (e.g., authority to do business) by a federal regulator, which retains implementation/enforcement responsibility *with respect to those standards only*; and,
4. Establishment of *broad national standards* by federal regulator with implementation/enforcement responsibility left to the individual states. A variation upon this approach could involve the *limited preemption of state laws* to address specific market problems. A good example is the Products Liability Risk Retention Act of 1981, later revised and expanded to cover all casualty risks (except workers' compensation) in the Liability Risk Retention Act of 1986 ("LRRA").[19]

C. FEDERAL STRUCTURES

1. *Direct federal regulation* (i.e., mandatory federal charter) — new federal regulator replaces state regulation in its entirety without discretion of regulated companies;
2. *Financial services super-regulator* — creates umbrella agency as new federal regulator for all financial services industries (similar to models in the United Kingdom and Australia, as well as Denmark, Japan, Korea, Norway, Singapore and Sweden);[20] and,
3. *Goal-oriented* restructuring of financial services regulation with reallocation and reassignment of responsibilities across existing agencies and authorities.[21]

D. UNIVERSAL OPTIONS

There are numerous variations in the manner in which these alternative structures could be implemented vis-à-vis the existing state-based structure. Changes could range from being very broad (e.g., direct federal regulation of all insurance activities) to very narrow (e.g., pertaining only to licensing or market conduct, or only to certain lines and/or consumers). Moreover, the changes can be developed with the involvement of any of the following entities: new federal insurance regulator/agency, federal bank and securities regulators, state insurance regulators and legislators, industry participants (underwriters, agents and brokers or other service providers) and consumers. Similarly, implementation and enforcement of changed standards could be left to the existing state authorities, transferred in whole or in part to either federal authorities (whether existing or newly-created) or to self-regulatory organizations.

Similarly, there are a number of complementary modulations regarding the extent to which regulations involve prior review and approval by authorities versus enabling conditional permission of self-certification

18 As federal regulatory involvement continues to increase in discrete areas, the U.S. system is moving away from a strictly state-based structure to a more combined state/federal structure as envisioned in this alternative. In the case of Canada, the role of provincial governments is quickly decreasing, leading to a more integrated federal-based structure for all financial services via its Office of the Superintendent of Financial Institutions. See Gibbons and Webb (2000) at 60-64.

19 Due to continuing problems in the availability and cost of liability coverage in the early 1980s, Congress passed these laws to increase consumer coverage options and facilitate group insurance programs through risk retention groups (RRGs) and purchasing groups (PGs). A key feature of these laws was the limited preemption of certain state laws and regulations that would otherwise hinder the formation and operation of such groups. This mechanism or structure is seen as a possible solution to the availability and cost problems that have arisen in the property market following the terrorist attacks, since similar issues in the liability market spurred the passage of these Acts.

20 See Gibbons and Webb (2000) at 60-64.

21 For example, one agency/authority would be responsible for each of the primary goals of financial regulation — protecting investors and consumers (e.g., Securities and Exchange Commission or Federal Trade Commission), controlling systemic risk (e.g. Federal Reserve), insolvency and guaranty funds (e.g. Federal Deposit Insurance Corporation or Office of the Comptroller of the Currency), and ensuring market functioning and competitiveness (e.g., Securities and Exchange Commission or Federal Trade Commission). As noted previously, however, such a structure runs a significant risk of creating jurisdictional disputes if specific responsibilities among these authorities are not clearly delineated. Proponents of this alternative generally find no continuing function for state insurance regulators within this system. See, for example, Wallman (1998) at 26-29.

or self-regulation by the industry and/or waivers by consumers. Such freedoms could improve regulatory efficiency significantly, by permitting the industry and consumers to assume more responsibility for compliance when reasonable and desired, yet maintaining regulators' fundamental oversight and intervention authority.

Indeed, these freedoms were a driving force behind the Federal Liability Risk Retention Act of 1986 ("LRRA"), as noted above, which sought to give insurance buyers greater control of their liability insurance programs in the midst of a market crisis which rendered coverage either prohibitively costly or altogether unavailable.[22] LRRA primarily sought to improve the market performance in liability lines by providing alternative coverage mechanisms (RRGs and PGs), and increasing competition among insurers, thereby reducing costs to consumers.[23] While these goals would be expected to consistent with those of state regulators, Congress recognized the potential for discrimination by the states against such alternative coverage mechanisms and enacted specific protections that exempted them from certain state laws that restricted group purchases (including the terms, rates and conditions of coverage) or were otherwise discriminatory.[24] Nevertheless, RRGs and other captives have continued to encounter regulatory frictions with state regulators concerning their authority to do business and the applicability of state assessments.[25] Absent further preemptions or clarifications by Congress, these frictions would be expected to increase if the Act were expanded to other lines such as property coverage.

A final variation involves reorganizing regulation around the type of insurance product and/or consumer. The insurance market as a whole is fairly well divided into discrete segments — life/health and property/casualty *lines*, personal/individual and business *consumers*, etc. Since the primary goal of regulation is to protect the consumer both in terms of market practices and solvency, it is worthwhile to consider a structure that is organized accordingly, since it might better reflect the underlying differences in each market's needs and dynamics, from which the potential benefits of regulation arise in the first place.[26]

These alternatives and variations reflect a multi-dimensional continuum, with areas of considerable overlap, as well as distinct and unique features. The discrete combinations of structures and options are limitless and, consequently, amorphous and difficult to analyze systematically. Nevertheless, it is important to recognize that each nominal alternative can be expected to perform quite differently depending on these variations that may be adopted alongside.

E. REGULATORY PERSPECTIVES

In addition to the structural options note above, the perspective from which regulators approach their oversight responsibilities can have an important bearing on the relative efficiency and effectiveness of any given combination of alternatives and options. The two basic variations in regulatory perspective are ***prescriptive approaches*** and ***prudential approaches***. The prescriptive approach characterizes the current

22 See Risk Retention Reporter, *Guide to the 1986 Risk Retention Act*.

23 See National Risk Retention Association, *Frequently Asked Questions*, downloaded at http://www.nrra-usa.org/about_faq.html.

24 A key feature of the Act concerns regulatory responsibilities. Although LRRA is a federal law, it still relies on state regulators for enforcement at the same time it constrains those enforcement powers (via preemption), which underpins the continuing regulatory conflict between state insurance agencies and RRGs/PGs. LRRA enables RRGs to be chartered in and regulated by their state of domicile, but largely exempts them from redundant oversight (including licensing, rate and form approval) in nonchartering states. Moreover, LRRA eliminates onerous residency and countersignature requirements of state laws on agents and brokers acting on behalf of these entities. IBID.

25 See Pilla, David. "Risk-Retention Groups Lobby Congress for Expanded Role." *BestWire Services*, April 4, 2002.

26 Such an organization, while theoretical and perhaps difficult to implement in practice, would better confine the direct and indirect costs of regulation to those accruing the corresponding benefits. By doing so, the inefficiencies and distortions caused by typical problems encountered such as cross-subsidization and negative externalities would be reduced.

U.S. system of regulation and utilizes a detailed set of generally *ex-ante* restrictions or requirements on regulated entities with regard to each aspect of their operations. The prudential approach, more evident in European regulation, provides greater overall flexibility and fewer specific restrictions, but relies on greater *ex-post* emphasis in oversight, such as more intensive regulatory monitoring and greater discretion for intervention by regulatory authorities.[27]

The crux of the differences in these approaches lies in the trade-off between more proactive and restrictive regulation that is designed to forestall problems (prescriptive approach) and more reactive and flexible regulation that is designed to quickly address emerging problems (prudential approach). Regulatory perspective has interesting implications in terms of shifting responsibilities away from regulators and providing greater discretion and freedom to regulated entities, particularly in the context of deregulation or self-regulation. In exchange for less regulation or greater self-regulation, the industry might face stricter enforcement and penalties for violations. By way of specific example, if the industry were permitted to self-regulate the licensing function, it might then be subject to more rigorous market conduct examinations and more severe enforcement penalties for violations.[28]

It also is essential to understand some of the fundamental predispositions of regulation regardless of the particular approach, as listed below.[29]

- Regulation naturally tends toward constraints and limits. This is often due to public and political perceptions that focus more on regulatory failures than successes.

- Regulators favor straightforward, objective and easily observable standards. The desire to maintain simplicity and treat regulated entities equally promotes rigidity in the face of unique or unusual circumstances.

- Regulators' evaluations are often geared toward clear cut, black and white assessments — regulated entities are either in compliance or out of compliance.

- Regulators' desire to maintain full authority and discretion undermines the goal of regulated entities for clarity on permitted and non-permitted activities and transparency in the regulatory process.

- Regulators often perceive that their task of ensuring compliance puts them in an adverse position with the entities they regulate (and vice-versa). Providing assistance and feedback to the industry to facilitate and strengthen compliance is sometimes seen as inconsistent with their enforcement role.

- There are few, if any, incentives for regulators to tend toward permissiveness or risk-taking when it comes to specifying, interpreting and enforcing rules and regulations.

27 See Grace and Klein (1999) at 10-11.

28 It is interesting to consider the effect of regulatory perspectives when juxtaposed with the tendency of regulators, noted previously, to be more concerned with regulatory *outcomes* than regulatory *processes*. In general, prescriptive approaches have strong preferences toward certainties in the outcomes (i.e., solvency and consumer protection), with less regard to the relatively high direct costs, rigidity and indirect or unintended effects of this approach. In contrast, prudential approaches are more cognizant of the adverse and inefficient effects of regulation and are willing to tolerate less certainty in the outcomes. The potential gains, however, can be significantly vitiated by the greater latitude and enforcement power often conferred upon regulators under prudential approaches. Thus, under the prudential approach, the industry potentially faces greater enforcement risk in exchange for greater operating freedom and flexibility (or less operating risk). This is due to the fact that the industry might carry out a given activity for some time before it comes under scrutiny by regulators. If regulators then have the authority to conduct enforcement retroactively, the resulting compliance costs could be substantial. Under the prescriptive approach, industry activities generally are constrained so that enforcement risk is lessened, but at the expense of increased operating risk (i.e., less operating flexibility).

29 See Wallman (1998).

- Failures often are easier to attribute to market malfunctions or violations and indiscretions by regulated entities, rather than to rigid, outmoded or even inappropriate regulatory standards or approaches that may, in fact, be the root cause of non-compliance and market malfunctioning.

These predispositions generally run counter to flexibility and innovation, even as those characteristics become more and more critical to the financial services industry in the current environment. They also are more "human" in nature than a product of regulatory structure, but nevertheless can be equally important determinants of regulatory efficiency and effectiveness. Furthermore, these tendencies underscore the very critical distinction between nominal rules and regulations as they exist on paper (i.e., scope), and their application in practice (i.e., conduct), which often is influenced strongly by individual interpretation. Consequently, in assessments of alternative structures, it is important not to overlook these tendencies even if they cannot be rectified or minimized by the regulatory structure per se.

IV Viewpoints for the Study

As noted above, the primary goal of this study is to develop a systematic and objective framework with which different regulatory alternatives/options can be assessed. Several viewpoints comprise the backbone of this framework, as outlined below. These viewpoints are intended to provide a balanced perspective on regulatory structure.

Empirical focus — many evaluations of alternative structures rely minimally on actual cost/benefit comparisons of the existing system versus the proposed alternatives. To a certain extent, this may be due to the lack of meaningful data on the relevant costs and benefits. For the proposed alternatives, such data are speculative at this juncture. Nevertheless, a more empirical focus will tend to produce less biased and more technically accurate results. Moreover, such assessments are not only more reliable, but also more defensible in the context of lobbying efforts, whether within the industry or with regulators and legislators.[30]

Regulate market failures — when the economic rationales for regulation become obscured by the goals of regulation, perverse results are likely to occur. Given the focus on outcomes by regulators and the difficulty that consumers have discerning the costs of regulation (which primarily they bear), there is a tendency for the process and costs of regulation to receive inadequate attention. Regulation serves the market best when it is focused on mitigating and correcting legitimate market failures, rather than replacing market mechanisms or achieving regulatory goals without regard to the means by which they are achieved.

The impact of regulation — beyond particular regulatory goals and outcomes, regulation often produces many indirect impacts by interfering with normal market forces. These indirect impacts are insidious because they are difficult to isolate and easy to attribute elsewhere. Nevertheless, these impacts can be substantial and often lead to even more regulatory intervention seeking to correct these distortions.

The costs of change — before the potential benefits of any alternative are realized, there will be a period of development and disruption that should be recognized in comprehensive and accurate assessments of relative costs and benefits.[31] The more extensive the change involved in a given alternative, the greater the costs of change likely will be, thus offsetting some of the potential benefits. Moreover, even relatively minor changes can produce indirect and unintended consequences that undermine the beneficial aspects of the changes (usually by causing new problems to emerge). While such consequences typically are not known in advance and are always difficult to quantify, history has shown that their prospect is real and, therefore must be considered in any proposal for change.

The industry is not monolithic — the industry, its markets and its customers comprise numerous interrelated yet typically distinct segments, as follows:

30 The existing state structure provides the only concrete basis for empirical assessments based on actual historical experience. Nevertheless, the lack of accurate and reliable data on the costs and benefits of regulation proved to be a significant limitation in this study, even for the existing state structure. While useable information on the direct costs — actual state expenditures on regulation and estimates of industry compliance costs — were obtained and analyzed, indirect costs could only be described, but not typically quantified.

31 This recognition is important in the interest of objectivity since omitting or ignoring the costs of change denies the existing state structure one of its primary advantages — that it is already in place and familiar, and that its weaknesses and shortcomings are known with comparative certainty vis-à-vis other alternatives.

- *by function* — regulators, customers, underwriters, reinsurers, agents and brokers, rating companies and other service providers;

- *by type of insurance* — consumer/individual or business, voluntary or compulsory, standard or non-standard, etc.;

- *by line of insurance* — personal (auto, homeowners, life, health), property & casualty (general property and liability, workers' compensation, business interruption, employee practices liability, directors & officers), and employee benefits;

- *by size* — applicable to underwriters, agents/brokers and consumer segments;

- *by regulatory reach* — traditional regulated markets, excess and surplus markets, alternative markets and foreign markets;

- *by method of distribution* — direct, by captive agent, by independent agent, self-insurance and risk retention; and,

- *by geographical market or locus of regulation* — state, regional, national/federal and international.

These myriad differences and segments make it exceedingly difficult to describe, let alone regulate the industry in broad terms. Arguably, each segment faces unique dynamics that optimally deserve a tailored approach. On the other hand, such micro-level approaches tend to be susceptible to arbitrariness or unfairness in the overall market and can adversely impact other segments. As noted previously, any initiative that tailors regulation more closely to subsets of regulated entities and/or consumers will produce significant benefits to the entire market, but at the risk of increased jurisdictional disputes and less uniformity as the number of regulating entities likewise increases.

Divining the optimal single approach, therefore, amounts to a weighing exercise involving numerous trade-offs and resolving mutually exclusive options that seek to maximize the overall net benefits. At the same time, as regulatory scope and/or structure changes, it is important to consider the effects on the incidence of the corresponding costs and benefits of regulation. Overall improvement, while desirable, will not necessarily ensure that the gains and losses are apportioned equitably among the market's participants. Nevertheless, the extensive nature of state-by-state control of so many aspects of insurance operations ensures that there are numerous opportunities to achieve net improvements and benefits for the overall market without imposing undue costs or risks to any particular segment.

V Historical Background

Historically, the regulation of the insurance industry has been marked by relatively brief episodes of rapid and dramatic change. These periods are well-known in the industry, but each has had very important implications on the evolving rationale for how the industry should be regulated and by whom.

A. 1860'S

- In 1863, the National Bank Act was passed permitting federal charters for banks. While the Act did not affect the insurance industry directly, it set the two industries on different regulatory courses.[32]

- In 1868, the differences between banking and insurance were further underscored in the seminal U.S. Supreme Court decision *(Paul v. Virginia)* that held that insurance was not commerce, thereby affirming the power of the states rather than the federal government to regulate the industry.[33]

Following this period, perceived market failures drove two important interim developments that led to the next period of significant change. An increasing number of insolvencies led to the development and use of rating bureaus, which sought to improve solvency by ensuring adequate rates. These bureaus, in turn, led to the acceptance and expansion of state management of insurance rates, either directly or indirectly, as an effective means of controlling excessive competition and maintaining market solvency.[34]

B. 1940-1950'S

- By the early 1940's, the regulatory management of the industry in the interest of market stability and industry solvency expanded well beyond simple rate setting to encompass areas of market conduct and the nature of competition itself. This trend culminated in the investigation and indictment of the South-Eastern Underwriters Association, a large rating bureau, for anticompetitive practices in violation of the Sherman Antitrust Act. In its defense, the rating bureau argued that since insurance was not commerce, the Sherman Act did not apply.[35]

- In 1944, in connection with the South-Eastern Underwriters Association case, the U.S. Supreme Court essentially reversed its prior decision of 1868, holding that insurance was, in fact, commerce.[36] The

32 See Harrington (2000-1) at 21; Sinder (2001) at 55.

33 See Harrington (2000-1) at 23; Grace and Phillips (1999) at 6; Sinder (2001) at 52-53.

34 See Harrington (2000-1) at 24-25; Grace and Phillips (1999) at 6-7.

35 See Harrington (2000-1) at 24-25; Grace and Phillips (1999) at 7-8.

36 See Harrington (2000-1) at 24-25; Grace and Phillips (1999) at 7-8; Sinder (2001) at 53-54.

decision threatened to unravel the preceding 75 years of state regulatory development and opened the door to greater federal regulation and oversight.

- The Court's reversal produced considerable confusion regarding not only established operating procedures within the industry, but also regulatory responsibilities and jurisdictions. Congress quickly clarified these issues by enacting the McCarran-Ferguson Act in 1945, which set forth its regulatory intentions. The Act once again affirmed the states as the primary regulating authorities of the insurance industry, but also set forth the conditions in which the federal government could preempt the states' authority.[37]

- In 1956 through the Bank Holding Company Act, Congress expanded the banking industry's limited insurance powers first granted forty years earlier by way of so-called "Section 92" of the Federal Reserve Act.[38] This expansion in bank insurance powers set the stage for regulatory conflict between the Office of the Comptroller of the Currency ("OCC") and state insurance regulators. The states responded by prohibiting bank insurance sales activities and refusing to permit the OCC to exercise its regulatory authority.[39] These measures went largely unchallenged and resulted in the states' maintaining their primary authority.

Over the next 40 years, the evolution of insurance regulation followed traditional lines, with court decisions, as well as periodic crises that were attributed to market failures, driving the major changes. Courts effectively narrowed the industry's antitrust exemption, while states grappled with a series of solvency and affordability crises that arose in each subsequent decade following passage of McCarran-Ferguson. Each crisis called into question the effectiveness of state regulation and spurred reconsideration of whether federal oversight was needed. Each time, however, the states responded by enacting reforms that ultimately forestalled direct federal intervention.

C. LATE 1990-2000'S

- The last two decades of the 20th century were marked by an acceleration in the evolution of the financial services industry in the United States. These developments involved both *expansion* — as each segment of the industry broadened its focus to national and international markets as well as new products and product markets — and *convergence* — as each segment's activities increasingly encroached upon the other segments through both product innovation and corporate consolidation across the segments. The dual-pronged nature of this evolution put tremendous pressure on the existing regulatory system. After nearly two decades of parallel debates and numerous failed initiatives, another landmark Supreme Court decision triggered further changes.

- The so-called "Barnett Bank" decision in 1996 effectively struck down the states' prohibition of bank insurance sales activities by underscoring the OCC's preemption rights over state laws restricting such activities. While the states retained their authority to regulate the insurance activities of banks, the exercise of that authority was subject to OCC preemption if it were deemed to "significantly interfere" with such activities.[40]

37 See Harrington (2000-1) at 25-26; Grace and Phillips (1999) at 8; Sinder (2001) at 54-55.

38 See Sinder (2001) at 56-57; Ketcham (1998).

39 IBID.

40 See Sinder (2001) at 57-58; Ketcham (1998).

- The Barnett decision led to the repeal of the offending prohibitions by the states. Meanwhile, the OCC quickly moved to expand the scope of bank insurance activities in a manner that threatened to usurp or render optional the states' regulatory control and give national banks a significant competitive advantage over the insurance industry.[41]

- The conflicting directions of the states' and OCC's regulatory actions highlighted both the gaps and overlaps in the existing regulatory structure for financial services, and demanded a solution to the increasing regulatory conflicts. Thus, unlike in previous episodes of dramatic change, Congress' consideration during this period was driven by the evolution of the industry rather than by any emergent crisis. The justification for maintaining functional separation among the different segments of the industry, as has been the regulatory tradition since the Glass-Steagall Act of 1933, was called into question, particularly as the pace and scope of these developments continued to increase. The industries found the regulatory structure increasingly constraining, while regulators increasingly grappled with jurisdictional gaps or overlaps and synergistic effects beyond their area of immediate expertise. Together, these limitations of the regulatory structure began to produce significant unwanted or undesirable distortions (especially competitiveness issues) that few could argue benefited consumers.

- After two years of Congressional debate and failed legislative initiatives, GLBA was enacted in 1999, primarily to facilitate the convergence of the financial services sectors via authorized affiliations and expansions in permitted activities.[42] A secondary, but equally important (and still to be realized) goal of the Act was to clarify regulatory responsibilities and minimize the competitive effects of differential regulatory oversight among the various sectors in the financial services industry.

- In less than two years since its passage, GLBA has triggered numerous changes in the financial services industry and its regulation. Already, the Act has demonstrated the potential to clarify or settle many of the conflicts and problems evident in the years immediately preceding its passage, while at the same time setting the stage for new conflicts and the revisiting of past conflicts (e.g., OCC preemption powers). Consequently, the near-term environment has the potential to be as significant a period of change as any that preceded it.

- The current context must also include the terrorist attacks of last fall (and their continuing threat), as well as the fraud-driven bankruptcy of Enron Corporation. These developments could spur even more extensive regulatory changes than might have been imagined following the passage of GLBA. It is still too early to discern exactly how these events will shape the evolution of the industry's regulation, but strong cases can be made for two radically different outcomes — that these developments could either derail the momentum for evolutionary and generally positive change spurred by GLBA, or help pave the way for more extensive and much faster change than otherwise would have occurred.

D. RECENT INDUSTRY PERFORMANCE[43]

As noted previously, the market conditions and financial performance of the industry that prevailed when state regulatory reforms and financial services modernization were inaugurated have changed dramatically for the worse. Coincidentally, this deterioration has accelerated since passage of GLBA in

41 See Sinder (2001) at 59-60.

42 IBID at 63.

43 Data from the Insurance Services Office, Inc. (ISO), *Insurer Financial Results*, unless otherwise noted.

1999 and is likely to have important ramifications on both the momentum and focus of reform efforts in the near future. Considerable attention has shifted from more general modernization efforts to addressing specific and more urgent problems in the market, encompassing supply and availability issues, as well as insurer solvency and financial health. Although ongoing reform efforts continue, the possibility exists that they will be overshadowed by more pressing initiatives, causing a loss of the momentum that has been generated to date. On the other hand, since many of the urgent issues revolve around the effectiveness of regulation, they also could spur more rapid and extensive changes to the regulatory structure. Given its importance to current considerations of the regulatory environment, a brief summary of the industry's performance over the last decade, and particularly in the last several years, is provided below.

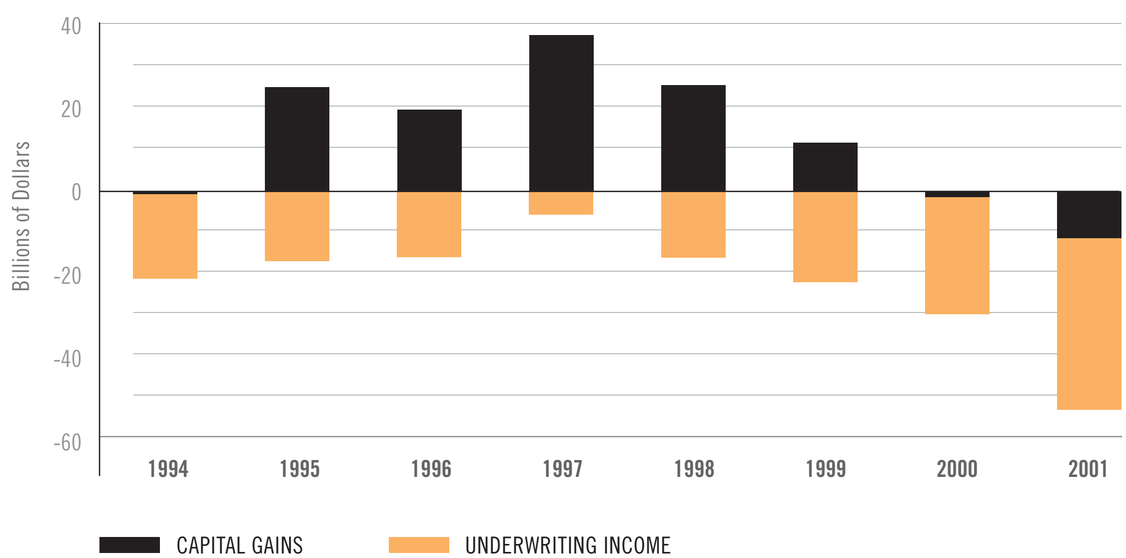
* * * * *

In the three years ending in 1997, the financial results of the property/casualty segment of the industry were buoyed by a continuing high level of investment returns and reductions in underwriting losses, which led to industry profits increasing to record levels in each successive year. Since 1997, however, the industry's performance has been steadily deteriorating, as investment returns have dwindled while underwriting performance has plunged again and remained dismal.

A closer look at this segment's performance over the 1991-2000 period reveals consistent underwriting losses averaging more than $20 billion per year in that decade.[44] Catastrophe losses contributed in large part to this performance, as six of the worst years for such losses all occurred in that decade alone — 1992, 1994-1996 and 1998-1999. Nevertheless, these historically high catastrophe losses simply magnified otherwise poor underwriting performance, as persistently sluggish premium growth and surging non-catastrophe losses helped produce underwriting losses in every year of the period.

Capital Gains Once Obscured Underwriting Losses in P/C Segement, But Now We Are Adding to Them

Annual 1994-2001



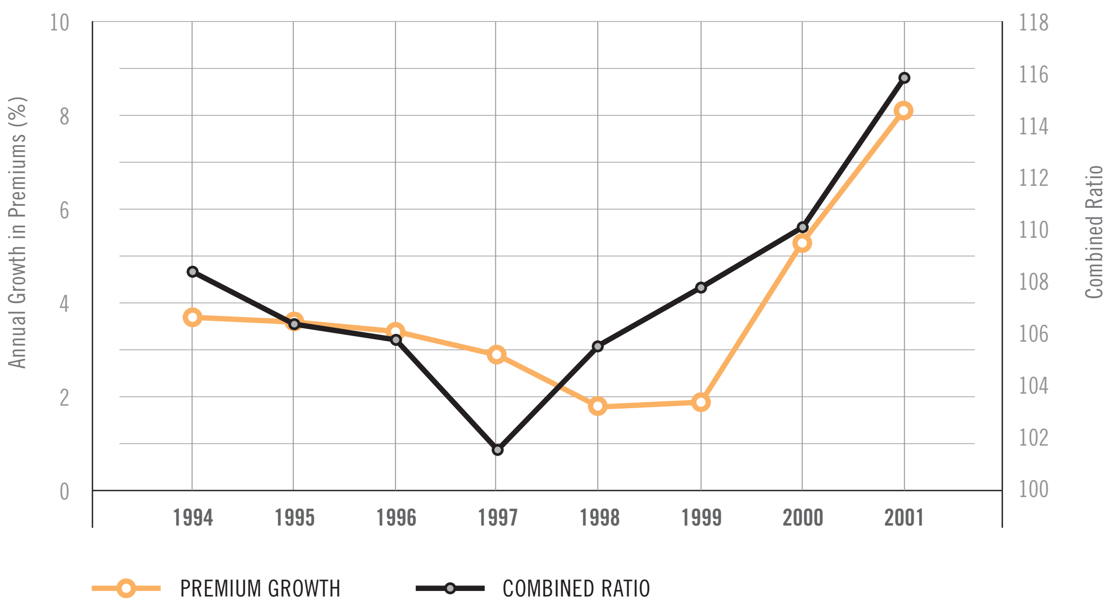
44 See Aon Risk Services of America at 8-9.

These losses would have caused much more significant problems among insurers but for high levels of investment returns that buttressed industry cash flow and profits. Capital gains surged dramatically through 1997, but fell sharply in 1998 and 1999. Meanwhile, underwriting performance marched downward in lock step as losses increased from less than $6 billion in 1997 to more than $23 billion in 1999. The segment's combined ratio reflected this deterioration, rising from 101.6 to 107.8 over the same period.

Soft market conditions finally bottomed following the worsening underwriting losses of 1998-1999,[45] although the increase in rates in 2000 failed to keep pace with the acceleration in underwriting losses that reached their worst levels since 1992, when the catastrophic losses of Hurricane Andrew were incurred.[46] Despite the absence of significant catastrophe losses in 2000, the segment's combined ratio deteriorated further to 110.1, while total capital gains declined for the third straight year and were negative for the first time since 1994.

Premium Growth Finally Rebounds, but the Combined Ratio Continues to Deteriorate

Annual 1994-2001



As 2001 began, the segment was hopeful that continuing rate hardening along with a return to more typical loss experience would finally lead to a much-needed turnaround in underwriting performance. Instead, the unprecedented cost and ramifications of the terrorist attacks, coupled with the failure of Enron and increased toxic mold claims, produced record losses, as the industry's combined ratio surged to 115.8,[47] its third worst level on record. Without capital gains to rely upon as before, the segment's financial condition came under increased pressure. Moreover, continuing losses from the terrorist attacks along with a surge in environmental liabilities (asbestos and toxic mold) are expected to continue to weigh on the segment in 2002 even as rates continue to harden. The drastic results posted by large reinsurers,

45 IBID at 12, 24-25.

46 IBID at 8-10.

47 See Greenwald (2002).

whose combined ratio surged from 108.4 in 2000 to an unsustainable 143.9 in 2001,[48] are also cause for concern for property/casualty insurers, since reinsurance capacity is being withdrawn in response.

While the industry has averted a crisis to date, the potential dangers are becoming more evident. Fortunately, additional terrorist attacks have not recurred in the interim, giving the industry several months to assess the damages and assimilate this new risk into the operating environment to some extent. Nevertheless, it is clear that the terrorist attacks have caused a market failure (manifest in inadequate supply) that the industry is unlikely to be able to resolve completely on its own. Against the backdrop of continuing poor financial performance, the emergence of this new market failure could easily trigger more significant difficulties for the industry, particularly should additional loss shocks occur in the near future.

E. IMPLICATIONS FOR THE FUTURE

This historical overview, while well-worn and simplified, is important in order to place the current environment in context, particularly given the recent further deterioration in operating conditions and their potential effect on reform efforts. As the various segments of the financial services industry weigh the possibilities and lobby for one form of change or another, more confusion than consensus has ensued. In many respects, the present is reminiscent of the period preceding passage of the McCarran-Ferguson Act in 1945 when the Supreme Court's reversal of *Paul v. Virginia* created considerable uncertainty in the industry. This time, GLBA has the potential to produce similar uncertainty by repealing Glass-Steagall and, while reaffirming McCarran-Ferguson, opening the door to federal regulation. While it remains to be seen how these tensions will be resolved, certainly the terrorist attacks, other loss shocks, and overall poor financial performance of the industry constitute new and potentially overwhelming factors that will assert themselves in the debate.

The industry and its regulators are considering numerous measures to address some of the most urgent problems, although their unprecedented nature has led to uncertainty regarding what measures are needed, what measures might be effective, and who should take primary responsibility for initiating and implementing them. Despite a steady accumulation of increasingly threatening evidence, the diffusion of the impact on the market may be contributing to some complacency among legislators, regulators and even the industry itself.

In addition, structural regulatory limitations are also contributing to the delay and difficulty in reaching a consensus. The existing state regulatory structure has demonstrated repeatedly that reaching a consensus and enacting reforms across 51 jurisdictions is not something that it can achieve quickly and effectively. As crises emerge, as in response to the terrorist attacks, the industry is forced to turn to the federal government seeking more rapid and effective responses. While Congress has been responsive to the industry's concerns, the absence of a continuing federal authority with the necessary capacity and expertise has proven to be a significant limitation in achieving needed changes. Together, these structural limitations have led to hesitation and delay that, while understandable, could prove to be quite costly should further developments occur in the meantime. In short, the industry and its regulators have managed to dodge a bullet so far, but numerous threats and risks remain that could quickly change the landscape and alter the reform and modernization efforts underway.

In summary, history underscores several important points that should be considered as the modernization effort and calls for structural reforms proceed:

Remember your roots. While few would disagree that the modernization effort is needed, Glass-Steagall and McCarran-Ferguson have been instrumental in defining the financial services industry. These laws have shaped the industry for more than 50 years and set the insurance and banking segments

48 "Attacks Make Reinsurer Results Even More Dismal." *Business Insurance*, April 8, 2002.

on different regulatory paths. Despite its repeal of Glass-Steagall, GLBA has, for the time being, helped to ensure that these regulatory paths largely remain distinct.

Regulation has limits and risks. While regulation can improve the workings of the industry, regulators have little control over many important factors — investment returns, the weather, the limits of science in discerning cause and effect or probability, and even human nature — that ultimately play a far greater role in the health of the industry. While regulation has succeeded in reducing overall market and systemic risk in some respects, in others it has contributed risk, which is contraindicated for an insurance industry that already operates in a constantly changing and uncertain environment.

There is no crisis (yet). GLBA focuses on the potential of the future rather than remedying an existing crisis. This is a critical difference. Moreover, the modernization effort is focused more on regulatory efficiency and should, therefore, be driven by objective assessments of relative costs and benefits, as opposed to more subjective or political concerns. As noted above, however, the industry has suffered a series of operating setbacks that have pushed it to the verge of crisis that, on one hand, may spur more rapid and extensive regulatory changes (as has occurred following past crises), or, on the other hand, may derail ongoing reform efforts by drawing attention to more urgent problems.

Do no harm. There is widespread agreement that regulation imposes costs on the industry and consumers that often exceed the corresponding benefits that might result. Some believe that regulation causes more problems than it resolves, and perhaps even creates or exacerbates market failures. While this study is not intended to settle that debate, it is reasonable to assert that regulation often has imposed additional costs and engendered risks to the industry and consumers through unintended consequences or miscalculation. Thus, regulatory reform presents a two-edged sword that, while promising potential benefits, raises the specter of harmful ramifications, even if unintended.

Carrots or sticks? History has evidenced an unmistakable pattern of regulatory crisis, followed by threat of federal intervention, and finally state reform that may ultimately have been more focused on the federal threat of preemption than on the underlying regulatory problem. Clearly, state-by-state reform has tended to occur more quickly and dramatically when this threat has been present. Three recent examples are instructive:

- The establishment of state guaranty associations in 1969-1970 in response to the threat of federal intervention to establish a federal guaranty association;
- NAIC's successful accreditation efforts and move toward risk-based capital standards largely were spurred by the threat of federal intervention following the spike in insolvencies in the late 1980's; and,
- The accelerated movement by the states to improve licensing uniformity over the last 2 _ years has been spurred by the threat of GLBA's NARAB provision.

To the extent that the industry seeks to achieve additional reforms within the state structure, these dynamics must be considered. At the very minimum, the states' ability to implement and achieve effective licensing reforms (in contrast to merely forestalling the creation of NARAB) provide a timely test regarding the inherent ability of state regulation to evolve at a satisfactory pace and manner. See Section VIII.

The devil you know. Some have interpreted or argued that GLBA establishes two critical points: 1) it reaffirms the authority of the states as the primary regulators of the insurance industry; and, 2) maintains the organization of financial services regulation along functional lines. While these are certainly prominent considerations in the debate over regulatory structure, perhaps more important and less disputable is the fact that GLBA has put the regulatory scheme in play, and could prompt another period of significant change. As was the case with the prior periods of change, there is considerable potential for improvement, as well as deterioration, particularly with respect to regulatory confusion and uncertainty.

High stakes require consensus. The number and varying nature of the positions and proposals being offered by each segment of the financial services industry, including its respective regulators, underscore the importance of the task at hand. As the debate continues and lines are drawn, achieving a consensus in the insurance industry (let alone the financial services industry as a whole) seems increasingly remote. Unless galvanized by crisis, it is reasonable to expect that the greater the differentiation in regulatory goals and preferences across the industry, the less likely that Congress and the states will be willing to contemplate dramatic changes in structure.

VI Fundamental Evaluative Criteria for Regulation

In this section, the evaluative criteria for assessing alternative regulatory structures are outlined. These elements are universal and each should be fully considered when comparing alternative structures in a general rather than an applied sense. By relying first on these elements, the theoretical soundness of each structure can be tested before delving into more specific evaluations.

These fundamental concepts are often overlooked due to a more limited focus on specific problems in support of one alternative or another. While such approaches may appear more practical or applied, they run the risk of merely tweaking fundamentally inefficient or distorting regulations, and, therefore, ensuring their continuation and potential to cause future problems, albeit, perhaps, in an incrementally improved fashion. The approach of this study is broader given its goal of establishing a systematic framework for evaluating alternative regulatory structures generally (rather than supporting a particular proposal), as well as providing sound, economic reasoning to support such evaluations as empirically as possible.

These analytical elements force consideration of whether regulation is tied directly to resolving a fundamental market *failure* as a threshold matter, rather than a market problem or other perceived need for regulation in the market. Next, the analytical framework is applied to the primary areas of insurance regulation — solvency and financial risk, consumer protections and market conduct, and pricing — to determine where and how regulation can be most efficient, while retaining its effectiveness. Once the proper focus of effective and efficient regulation is established, a more applied review of the various direct and indirect costs of regulation follows.

A. TYPES OF MARKET FAILURES

The primary rationale for regulation is to address market failures, which encompass several discrete but related categories in the context of the insurance industry. As a starting point, it is important to distinguish between market *failures* and market *problems*. All markets experience problems, which stem most basically from the opposing goals of and conflicts among market participants. This is precisely the role that markets are intended to mediate by resolving differing preferences (not only between buyers and sellers, but among competing buyers and among competing sellers). In contrast, market *failures* represent structural flaws that cannot be overcome or corrected by competition, or that preclude viable competition in the first place. The primary market failures for which regulation usually is prescribed and accepted are discussed below.

1. BARRIERS TO ENTRY OR EXIT

Absent the effects of regulations themselves, there is no evidence of significant entry or exit barriers to the market among any of the different segments in the industry. To the contrary, there is considerable evidence that the insurance market, particularly the commercial lines, is structurally competitive, as concluded in numerous studies over an extended period of time.[49] None of the typical market-related

49 See, e.g., Joskow (1973) at 375, 391; Cummins and Weiss (1991) at 117-154; Feldhaus and Klein (1998) at 35-36, 38; Harrington (2000-2) at 15-24; Skinner and Klein (1999) at 14. See also, more generally, Cummins and Weiss (1992); Klein (1995); Grace and Barth (1993). Typical criteria used to assess the structural competitiveness of markets include the number of sellers and buyers, the range of consumer options, differentiation in pricing, firm market concentration, and the existence of excessive prices or profits.

barriers are present in the insurance industry and it is generally believed that inherent entry barriers are low.[50] The primary exit barriers are economic or practical in that exit decisions typically cannot be implemented quickly, often involve the forfeiture of significant investments in the given market (and loss of a national presence), and subject the exiting company to significant incremental costs.

The most significant entry and exit barriers to the market are those imposed by its regulation. Imposed entry barriers include company and agent licensing, agent appointments, countersignature requirements and minimum financial requirements.[51] Such entry barriers are intended to protect consumers, but in many respects can be harmful to consumers. The direct costs of compliance are inevitably passed on to consumers. More significantly, however, entry barriers tend to reduce competition among service providers and increase prices to consumers.[52]

The primary exit barriers imposed are "lock-in" rules, which are even more constricting when coupled, as is usually the case, with restrictive rate and/or form regulation. Once again, such exit barriers are intended to protect consumers, but do so at the cost of reduced insurer profits, which ultimately undermine solvency and tend to reduce the availability and quality of insurance products to consumers.[53]

2. MARKET CONCENTRATION AND FIRM MARKET POWER

Market concentration is an important element in the context of several unique and interrelated features of the insurance industry, as follows:

- The industry's limited exemption from federal antitrust laws (i.e., the Sherman Act, the Clayton Act and the Federal Trade Commission Act) conditioned upon affirmative antitrust regulation by the states;

- The permission of cooperative activities among competitors that are typically prohibited, ranging from the sharing of information on historical and prospective loss costs to explicit rate-setting in the interest of promoting the efficient development of accurate pricing information and risk evaluation, as well as preventing excessive competition that might unduly pressure insurer solvency; and,

- The use of form regulation as a means to ensure minimum levels of coverage and promote standardization. Standardization benefits both consumers (by facilitating price comparisons) as well as underwriters (by generating comparable loss experience data that can be pooled accurately). Form regulation, however, distorts the market by reducing the degree of product differentiation that would otherwise exist. If suppliers are not permitted to differentiate their products in terms of their coverage and other features, then they are forced to compete in other areas (e.g., price and level or quality of service).[54] Thus, form regulation is not necessarily advantageous or disadvantageous to consumers — it *can* promote greater competition (by facilitating price comparisons), but it does so at the cost of potentially distorting the market or, worse, merely providing the appearance of greater competition.

50 See Macey and Miller (1993) at 38; Feldhaus and Klein (1998) at 36; Harrington (2000-2) at 18; Skinner and Klein (1999) at 14. In this context, entry includes both new service providers as well as the expansion of existing service providers into a new market.

51 For companies and agents/brokers operating in multiple states or nationally and/or across multiple lines, state-by-state licensing requirements constitute a particularly significant entry barrier with a corresponding adverse limitation on overall competition.

52 See Feldhaus and Klein (1998) at 55-57.

53 See Harrington (2000-2) at 34-37; Macey and Miller (1993) at 110.

54 Moreover, a distinction must be made between the nominal standardization of forms and the corresponding standardization of actual loss coverage, since forms by themselves do not necessarily reflect insurer claims-paying ability or willingness under the range of particular circumstances giving rise to claims. These factors, along with other quality of service variations, run counter to the benefits of standardization for consumers.

Each of these features should tend to reduce competition and facilitate coordinated action by firms, typically leading to higher industry concentration and individual firm market power. There is little evidence, however, to support such a characterization of the insurance market, as noted previously. In short, the relatively low levels of industry concentration coupled with the relative ease of entry are not conducive to anticompetitive behavior.

Firm size and industry concentration must be evaluated on many different levels, with respect to the market's different service providers (i.e., reinsurers, insurers, and agents/brokers), the relevant market (i.e., local, state, regional, national, continental or international), and the type of insurance, which is beyond the scope of this study. It is important to note, however, that firm size and industry concentration are driven by many legitimate factors that need not be subject to regulatory scrutiny as a general matter. Given the degree of consolidation that has been occurring in recent years across all segments of the industry, firm size and industry concentration have increased significantly. Many academic studies have addressed the question of whether increasing concentration reflects less competition (negative) or the increasing dominance of more efficient firms at the expense of less efficient firms (positive). With respect to insurance specifically, a few studies have found a relationship between industry concentration and profitability.[55] It is not clear, however, whether such increased profitability stems from market power or simply better performance due to efficiency.[56] In the case of the latter, regulatory efforts to reduce market concentration effectively rewards less efficient firms at the expense of more efficient firms, which clearly is not a beneficial outcome.[57]

3. EXTERNALITIES

Externalities refer to a cost or benefit that arises from an economic transaction which is borne by parties not involved in the transaction and results from the failure of the transaction price to account for the externality.[58] This economic principle is especially critical in evaluating alternative regulatory structures, given the generalized tendency of decentralized, state-based regulatory structures to create externalities, particularly as regulated markets expand beyond state borders (as is the case for insurance).

Externalities can be either positive — when a party accrues a benefit without a corresponding cost (frequently referred to as a *free-rider* effect) — or negative — when a party accrues a cost without a corresponding benefit (*spill-over* effect).[59] Generally, externalities are not "either-or" propositions. One party's positive externality is another party's negative externality, such that, from an economic perspective, all externalities are undesirable since they involve a distortion in relative costs and benefits. These concepts are best illustrated by way of examples:

- uninsured or underinsured parties are prone to losses that cannot be claimed and, therefore, may be

55 See, e.g., Harrington (2000-2) at 48.

56 Assessments of relative profitability should account for differences in risk. A 1995 study by ISO based on industry performance in the 1979-1993 timeframe concluded that larger insurers were more profitable and less risky than smaller insurers, while commercial-lines insurers were more profitable and more risky than personal-lines insurers. See ISO, *Risks and Returns: Property/Casualty Insurance Compared to Other Industries*, December 1995. Notwithstanding these findings, the aggregate combined ratio for the largest property/casualty insurers was significantly worse than average in 2001 (118.2 versus 115.8 — see Greenwald (2002)), which may indicate that larger insurers may face higher than average risks in catastrophic losses and/or in underwriting the risks of large commercial insureds that have the potential to generate unusually large losses.

57 Industry concentration among agents and brokers is significantly higher than for insurers, but still not high enough to prevent continuing mergers and acquisitions by the leading firms. The wide range and increasing sophistication of risk management and ancillary services demanded by commercial insureds on a global basis has provided much of the impetus behind the consolidation among agents and brokers, as they seek to expand and round out capabilities to serve such clients. Consolidation among insurers also has been a factor since volume requirements for agents and brokers tend to increase along with insurer size. See "CNA Chairman Looks at the Future of the Agency System." *The Rough Notes Magazine*, January 1999; Schiff, Samuel. "Agency System Lives but Continued Agency Survival Will Require Adapting to Changes." *The Rough Notes Magazine*, February 1999; Boone, Elizabeth. "Trends for the New Millennium." *The Rough Notes Magazine*, January 1999.

58 See Spulber (1989) at 46.

59 IBID.

borne instead by other parties, whether or not they are involved directly in the loss occurrence or insurance transaction;

- restrictive risk classification regulations tend to force lower-risk insureds to "subsidize" higher-risk insureds by interfering with the natural relationship between risk and premium levels; and,

- states that fail to regulate adequately or efficiently either impose costs and risks upon other states, or benefit unfairly from the more rigorous and efficient regulation by other states.

The last example demonstrates why externalities are key in evaluating alternative regulatory structures. Theoretically, regulation is considered a "public good," which refers to goods or services that can be consumed simultaneously by everyone, even if they do not purchase or pay for it directly.[60] A secondary economic principle that governs the supply of public goods is the *Pareto optimal provision*. When applied to regulation, this principle holds that regulation should be "produced" at the most *decentralized* layer of government capable of internalizing all the economic costs and benefits associated with regulation.[61] Thus, this principle is at the core of the debate regarding the proper jurisdictional size, as well the locus and structure of regulation.

The principle, on its face, is deceptively simple and appears to favor smaller regulatory jurisdictions. The principle's apparent bias toward decentralization is premised on the ability of smaller jurisdictions to be more responsive to particular preferences in those jurisdictions. As jurisdictions become larger, it becomes more difficult to address particular preferences, which can impact the ability of regulation to achieve its stated goals. Logically, two of the primary rationales for maintaining the state regulatory structure of insurance are its abilities to tailor products and services to unique state market conditions and requirements, and to offset consumer information problems and deficiencies (discussed below).[62]

The primary offset to the benefits of decentralization is its tendency to generate negative externalities upon other jurisdictions. A common example is when a given jurisdiction (often smaller) fails to conduct sufficient oversight and either relies on other jurisdictions to do so ("free-rider" effect) or causes market problems (e.g., fraud or insolvency) whose impact is not confined to that jurisdiction ("spill-over" effect). Inefficiencies related to redundancies and diseconomies of scale or scope in regulation are also key disadvantages of decentralized authority. These shortcomings are the chief source of complaints and criticisms regarding state regulation.

In practice, therefore, it is difficult to evaluate this ostensibly simple principle. As a starting point, merely *identifying* all of the costs and benefits associated with regulation is a complex matter. Accurately *measuring* those costs and benefits (including their incidence — i.e., by whom the costs are borne and by whom the benefits are accrued) is even more difficult. Nevertheless, given the state-based structure's susceptibility to generating negative externalities, assessments of alternative structures must address these complex but important considerations.

4. INFORMATION CONSTRAINTS

An unrestricted, cost-effective and balanced flow of accurate and timely information to market partici-

60 Common public goods besides regulations include naturally-occurring air and water, national defense, and public radio. The notion of direct payment is key in differentiating between public and private goods. Due to the lack of direct payment or readily apparent consequence, consumers of public goods tend to be insensitive to their ultimate cost.

61 See Grace and Phillips (1999); Inman and Rubinfeld (1997); Oates (1972).

62 As the market becomes broader, these rationales may begin to benefit consumers more than insurers. While insurers also benefit from the ability to tailor products to specific risks, the maintenance of many discrete jurisdictions runs contrary to the fundamental objectives of many insurers — gaining economies of scale through market penetration and pooling risks across larger populations. This divergence between consumer and insurer preferences is least evident in commercial lines, especially for larger consumers whose need to obtain coverage nationally or internationally tends to outweigh their need for tailored coverage and regulated protections.

pants is an essential precondition of market functioning irrespective of the particular market. The quality of information in the market is driven by three factors:

- **Disclosure:** developing and reporting a comprehensive set of information.
- **Access:** making the information available to those who need it.
- **Understanding:** making the information useful by ensuring its consistency and comparability, as well as its presentation in a readily understandable manner.

In addressing information constraints, a key consideration is which of the above factors should be subject to regulatory control. In insurance markets, the chief manifestation of information constraints is *asymmetry* or *asymmetric information*, which exists when one party to a transaction has relevant information that the other party lacks.[63] While asymmetry does not necessarily have to lead to problems, it certainly raises the potential for problems and provides one of the strongest justifications for regulating the insurance market.[64] As discussed further below, asymmetry also contributes to another insurance market failure — *principal-agent conflicts* — that arise when one party, due to a lack of information, is unaware of the actions of the other that might affect future performance on the insurance contract.

Throughout the financial services industry, the primary thrust behind regulating information constraints has been centered on ensuring adequate levels of disclosure.[65] While regulators also seek to ensure that the information, once disclosed, is obtainable and understandable by consumers, regulation cannot compel consumers to utilize such information, particularly if they perceive no hazard in their failure to do so. Consequently, regulation may undermine consumer willingness to obtain and analyze the relevant information (whether directly or through an intermediary), while promoting more exclusive reliance on regulation to do so on their behalf. This is particularly relevant in personal and health lines among individual consumers, but less so in commercial lines where consumers are more sophisticated and able to justify the costs of such evaluations.

When buyers and sellers lack adequate information, they are unable to express their preferences properly in terms of products, distribution methods, quantities and prices they are willing to demand and supply, respectively. While such constraints will not preclude the market from functioning, they will cause the market to function at suboptimal levels that fail to maximize overall welfare. By providing distorted signals to both buyers and sellers, the market will tend to experience sharp fluctuations in market-clearing behavior, characterized by alternating periods of shortages or excess supply and excessive or inadequate pricing,[66] as well as less suitable product features and a lack of innovation. In short, overall market efficiency deteriorates for all participants.

For insurers, information constraints or asymmetric information lead to *adverse selection* (inadvertent risk assumption) and *moral hazard* (imprudent risk assumption).[67] The prevalence and significance of these information constraints have led insurers to develop sophisticated techniques to minimize their

63 See Skipper and Klein (1999) at 12.

64 Insurance itself is a common response to asymmetric information problems in the financial services industry generally (e.g., deposit insurance or Federal guarantees of pension benefits). See Herring and Santomero (1999) at 7.

65 While regulators also audit and analyze disclosed data, those functions are somewhat less critical since they can be undertaken to some degree by willing consumers, competitors, other service providers and intermediaries, provided they have access to adequate information. Thus, the regulatory authority to compel accurate and meaningful disclosure is one that cannot be transferred or replaced, and, in turn, empowers other market participants in undertaking their own analyses and thereby assuming quasi-regulatory roles that benefit the market.

66 These market imbalances can become particularly pronounced in the insurance industry due to the interplay of underwriting cycles and investment risks.

67 See Grace and Klein (1999) at 6; Varian (1992).

effects. These mechanisms include actuarial and probability analysis, contract stipulations and provisions, risk classification and selection, and pricing.[68] Adequate information for insurers is both comprehensive with respect to particular risks, as well as broad in terms of sample size, to ensure accurate pooling and probability assessments.

With the benefit of adequate information, insurers are able to more accurately underwrite risks, price products and forecast losses, thereby producing corollary benefits in terms of solvency, profitability and overall efficiency. Arguably, affordability and availability also are enhanced. The hallmarks of a well-functioning market include the growth and success of insurers that avoid adverse selection and moral hazard, which, in turn, hinges on their ability to classify a range of risks into a homogenous group. This classification, in turn, is dependent not only on accurate and timely information, but also the freedom to discriminate among risks. It is this discrimination, however, and the disadvantaging of some buyers vis-à-vis others that often serve to generate regulatory attention that seeks to limit the very actions that are essential to insurers' success and ongoing viability.[69]

For consumers, information constraints tend to be technical rather than absolute and center on their inability or unwillingness to obtain, analyze and understand the information required to make optimal purchasing decisions. The essential information required by consumers includes prices, the implications of contract provisions, the quality of service and the ability of the insurer to meet its obligations.[70] It is costly for consumers to obtain and understand this information, in inverse proportion to their size and also in relation to insurers, which produces asymmetry (and potentially, in turn, principal-agent conflicts) in insurance transactions. Regulation seeks to improve consumers' decision-making abilities by requiring sufficient disclosures in a simplified and comparable format, as well as by monitoring insurer solvency and claims-paying ability on behalf of consumers.

To a certain extent, these regulatory goals go beyond merely addressing the information constraints and effectively may relieve consumers of this difficult but essential responsibility. Among smaller and less sophisticated consumers, regulatory oversight may be perceived as a guarantee, which is contrary to the goal of regulation, not to mention the nature of insurance. Of course, that these perceived "guarantees" are further reinforced by actual guarantees (via guaranty fund protections) only exacerbates this weakness in the market.

5. PRINCIPAL-AGENT CONFLICTS

Principal-agent conflicts are present in all markets and the resolution of these conflicts is the prime function of markets. While unavoidable, these conflicts have the potential to disrupt market functioning and lead to reductions in overall welfare. There are three major sources or causes of these conflicts in insurance transactions.

First, as is typical in any market, the fundamental goals of each party in an insurance transaction differ. Insurers seek profits by maximizing premiums and minimizing paid loss claims, while consumers seek savings by minimizing premiums and maximizing benefits and coverage.[71]

Second, both insurers and consumers are limited in their ability to monitor and control the other, giving rise to asymmetry and setting the stage for conflicts between the parties.[72] Insurers may assume risks in transactions with some consumers that threaten contracted benefits to other consumers, or simply

68 See Grace and Klein (1999) at 6. Significantly, all of these techniques generally are subject to close regulatory scrutiny.

69 See, generally, Harrington (2000-2). Notably, one of the key features of LRRA is the preemption of prohibitive or restrictive state laws that preclude insurers from offering preferential rates, terms and conditions to groups, even if they are justified by actual loss and expense experience. See National Risk Retention Association, *Frequently Asked Questions*, downloaded at http://www.nrra-usa.org/about_faq.html.

70 See Grace and Klein (1999) at 6.

71 IBID at 7.

72 See Skipper and Klein (1999) at 13.

refuse to honor presumed or even actual obligations. Consumers, on the other hand, may make suboptimal purchasing decisions or fail to implement and/or maintain sensible measures to control losses.[73]

Third, in both purchase negotiations and disputes over contract terms, insurers typically have a significant advantage over consumers. This advantage stems not only from a better knowledge of risk management and contract terms, but also from having greater resources and bargaining power over individual policyholders.[74]

Principal-agent conflicts lead to suboptimal consumer decisions, excessive insolvency risk, and abusive market practices.[75] Regulation seeks to supplement or even substitute for market mechanisms that are constrained by these conflicts in order to resolve them in a fair and balanced manner. While the first two of these conflicts can be equally detrimental to insurers and consumers, regulation seems most driven by the third type, regarding proficiency and market power, where the consumer is considered most disadvantaged. In an effort to resolve this conflict more in favor of consumers, regulation also tends to mediate the other two types of conflicts in a similar fashion, usually to the detriment of insurers and to the more disputable benefit of consumers. While these conflicts are related, it is not settled that they need to be regulated similarly or that the market is unable to reconcile them more effectively and efficiently on its own.

B. LINKS BETWEEN MARKET FAILURES AND REGULATION

Market failures occur in varying degrees of severity, and are distinct from market problems, not to mention social and political (i.e., non-market) objectives. Market failures are characterized by their persistence and substantial impact, as well as the inability of the market to resolve them satisfactorily — by maximizing the collective welfare of all market participants without bias. At the very minimum, once a failure has become severe enough to warrant regulatory intervention, it should be amenable to being solved by regulation. Surprisingly, this simple tenet is often lost in the process of promulgating and enforcing regulations. Ideally, the goal of regulatory intervention should be to correct rather than offset or control the structural flaw, leading eventually to a market that remains stable, functional and less dependent on regulation to manage its predisposition to the particular failure in the future.

The structural nature of market failures, however, frequently produces failures in groups, due to their typically high degree of interrelatedness. As noted above, information constraints often lead to externalities or principal-agent conflicts; barriers to entry often lead to market concentration; and, principal-agent conflicts can lead to excessive insolvencies. This has important implications for regulation since the interrelatedness of market failures complicates addressing them in an independent manner. Many times, addressing one type of market failure can trigger or exacerbate others if the market and its failures are not viewed more holistically.[76] Most if not all undesirable outcomes in the insurance market can be traced to one or more market failures, as should be expected. Unfortunately, once intervention in the market is deemed warranted and then implemented, there is a tendency to focus on the regulatory response at the expense of the underlying failure, which inevitably leads to additional regulation or a continual fine-tuning of existing regulations.

73 IBID.

74 IBID.

75 IBID at 8.

76 Insurance regulation comprises a loose collection of discrete actions (i.e., licensing, financial regulation, rate and form regulation, market conduct, etc.), each with a particular focus or set of goals. Viewed collectively, these actions may be seen as a holistic approach to regulating the insurance industry and market, although that is not what is meant here. An effective holistic approach demands that the various activities be performed in concert to achieve a desired *overall* outcome in the most efficient manner possible. A better description of insurance regulation is that nearly every aspect of insurance transactions is subject to regulatory scrutiny and that the spectrum of regulatory activities, while broad in the aggregate, tends to involve significant redundancies. While these redundancies arguably provide additional security, they have equal potential to be unnecessary, inefficient and even in conflict with each other.

Regulatory focus often shifts toward the *administration* of a regulation, and away from its *impact* on the underlying failure. This is evident in many areas of insurance regulation. For example, licensing regulations generally are accepted as a proper control over the authority to conduct insurance transactions. Consequently, debates regarding licensing are focused almost entirely on how licensing is best accomplished, rather than on whether licensing is contributing meaningfully to regulatory authority and consumer protection. Even more troubling are instances in which regulatory requirements successfully generate the information needed to identify a problem and trigger intervention, but oversight fails to detect the problem due to inadequate analysis or communication on the part of regulators.[77]

At the extreme, regulation can further embed the very structural problem it seeks to address. Rather than serve as an incentive toward structural improvement in the market, the regulatory effort often encroaches upon the market and ensures that the failure (or threat thereof) persists by thwarting or damping the discretion of the market participants toward resolving the problem. Alternately, this could be described as substituting the judgment of regulators for the judgment of the insurance industry and its customers. Regulatory intervention can become so intrusive that normal market forces are thwarted, leading to a persistence of the threat of failures and, thus, the need for continued or even increased regulatory intervention. In short, regulation can act as a crutch that weakens rather than strengthens market forces and dynamics, which is exactly contrary to the original goal of the intervention.

C. REGULATORY FOCUS

Due to the fiduciary nature of the financial services industry, regulation of product/service providers generally is accepted and considered an effective means of maintaining market confidence and stability — two critical foundations of efficiently functioning markets for financial services. The importance of market confidence and stability, however, go well beyond mere efficiency concerns. In the insurance industry, the weakening of these foundations can introduce severe distortions (e.g., weak companies competing with excessive risk) and substantial externalities (e.g., unpaid loss claims being shifted to other consumers and investors), reduce insurance supply and decrease overall coverage, increase frictional costs by spurring litigation, and adversely impact the businesses and other activities protected or facilitated by insurance.[78] Given the potential for these large and adverse impacts, regulation seeks to minimize threats to these critical foundations, via direct control and limitation of insurers, thereby moderating unfettered market forces that might tend to produce different results. In short, regulation attempts to provide more cost-effective outcomes than the market would produce on its own.[79]

As noted above, regulatory intervention is most effective if it is confined to addressing unambiguous market failures with the goal of correcting those failures and restoring the proper and healthy functioning of the market. Before intervention takes place, the subject failure should meet two basic criteria. First, the failure should be causing substantial adverse effects, whether in terms of actual impacts or via the

77 The United States General Accounting Office (GAO) repeatedly has evaluated insurance oversight in the context of insolvency and fraud problems that have surfaced in recent years. While GAO has recognized other factors unrelated to regulatory oversight that have contributed to these problems (such as business cycles and other macroeconomic pressures), in many cases it attributed significant blame to lax or inadequate regulatory processes that were often unconnected to the specific compliance activities of the regulated entities involved. In particular, the GAO identified time lags in oversight and analysis, insufficient communication and coordination, inadequate reporting standards (regarding reinsurance data, consolidations, holding companies and interaffiliate transactions), budget limitations, jurisdictional complications, and fundamental limitations in NAIC's authority. While GAO recommended *more* regulation and oversight, in most cases it emphasized the need for *better* regulation and oversight via an improvement in processes rather than an increase in regulatory requirements. See, generally, GAO (2000).

78 Certainly, the recent terrorist attacks are being felt by insureds not only with respect to their particular insurance coverages and rates, but also their fundamental ability to conduct business due to an inability to adequately address risk exposures.

79 The natural competitive forces in the insurance industry, as in any industry, produce insolvencies and closures that do not constitute de facto evidence of market failures. To the contrary, the *absence* of failures or insolvencies suggests inadequate competition that likely stems, in part, from excessive regulatory interference and is manifest in reduced supply and increased prices. See Skipper and Klein (1999) at 23-24. While the existence of significant market failures in the insurance industry increases the threat of insolvencies and closures, the same is true for all segments of the financial services industry.

threat of unacceptable levels of risk. Second, the regulation must demonstrate that it is able to lead to a significant improvement in outcomes vis-à-vis free market performance.[80]

Since regulation imposes definitive costs on the market that run counter to consumer welfare,[81] but only speculative benefits (depending upon the amenability of the failure to regulation as well as the effectiveness of the conduct of regulation), the mere existence of market failures is insufficient to warrant regulatory intervention. The failures must have *demonstrable* adverse effects upon market participants. Furthermore, the intervention must generate a sufficient return, via improved market performance and outcomes, on the costs it imposes; otherwise, the intervention merely exacerbates the failure by imposing incremental costs without a corresponding or even demonstrable improvement in market functioning, including, ideally, the restoration of its self-governing and self-correcting capacity. In short, the purported benefits of regulation, no matter how significant or widely-accepted, must be evaluated in conjunction with its costs, both explicit and implicit.[82]

The hallmark of an efficient and competitive insurance market is one that minimizes the *overall cost of risk* (see inset next page), which comprises three elements:[83]

- the cost of losses;
- the cost of loss control (i.e., measures to reduce the frequency and severity of losses); and,
- the cost of risk reduction and transfer.

Regulation of insurance tends to be focused disproportionately on the third element — via regulation of prices, policy forms and market conduct — often at the expense of the other two elements, which have the potential to impact the market much more significantly. Perhaps the biggest criticism of regulation is that by attempting to control the *incidence* of the market's costs — i.e., who bears the costs — by interfering with the market's normal allocating functions, it tends to increase overall costs and, thus, decrease overall welfare even if it manages to reduce costs or loss exposures for a given consumer segment. Competitive and efficient markets are unbiased regarding the incidence of costs and more directed toward minimizing them overall by providing strong incentives for efficient behavior. For insurers, this means classifying risks accurately in order to price them properly and avoid adverse selection. Accurate risk classification, in turn, provides strong incentives to consumers to control losses in order to reduce premiums and uninsured losses.[84] These incentives are the key determinants of the market's efficiency and are often influenced significantly by regulation.[85] Consequently, every regulatory response should be judged based on its effect on these incentives, since any measure that reduces these incentives for solid underwriting and/or loss control tends to increase overall consumer costs, undermine insurer profitability or financial condition, and increase risk to both insurers and consumers.[86]

80 See Grace and Klein (1999) at 5-6.

81 See Harrington (2000-2) at vii. Such costs are passed onto the consumer in a number of different ways. Most generally, they cause an increase in prices and a reduction in output; however, these costs also have other less obvious ramifications, such as reduced service levels and, if not passed onto the consumer, a reduction in insurer solvency margins.

82 This simple construction is belied by the difficulties in establishing the benefits of regulation in an industry that has been regulated extensively for many years. Assessing the benefits of regulation requires speculation as to what might have occurred in its absence, which is, at best, a theoretical exercise. In contrast, the costs of regulation, while also difficult to identify with precision, at least can be assessed more empirically, as discussed in the next section.

83 See Harrington (2000-2) at 23-24.

84 See Harrington (2000-2) at 23-24.

85 In the context of market failures discussed earlier, prices represent the single, most critical type of information between buyers and sellers that permit them to mediate their different preferences in any transaction. Direct regulatory control invariably distorts those prices, thereby producing a new information constraint even as it seeks to resolve an existing one.

86 See, generally, Harrington (2000-2); Grace and Klein (1999).

The Overall Cost of Risk

The concept of the overall cost of risk represents an example of a holistic view of insurance and its regulation. The Risk Insurance and Management Society (RIMS), in conjunction with Ernst & Young, conduct an annual survey of the overall cost of risk in the United States and Canada ("RIMS Benchmark Survey"). The overall cost of risk in the survey is defined as the aggregate of premiums, retained losses, internal administration (including costs associated with an organization's risk management functions) and certain outside services.

The survey indicates that the overall cost of risk to corporations in the United States and Canada has fallen sharply over most of the last decade, from $8.30 per $1,000 of revenues in 1992, to $4.83 per $1,000 of revenues in 2000. The decline was attributed to reduced premiums, higher coverage limits, lower deductibles and lower losses.

While some of these factors can be attributed to general economic conditions, they also reflect a competitive market in which average costs are declining. Costs are expected to rise, however, in 2001 given the hardening in the market coupled with a surge in losses.

See Zinkewicz, Phil. "Research Reports Outline Changing Roles of Brokers, Banks, Insurers and Risk Managers," The Rough Notes Magazine, July 1999; "Cost of Risk Declines for Second Consecutive Year." Insurance Journal – Property and Casualty Magazine, December 10, 2001.

Although nearly every aspect of insurance transactions is subject to regulation, the most effective intervention is limited to solvency or limiting financial risk, and consumer protections or policing market practices, where market failures are most evident and harmful.[87] From a more academic perspective, the rationale for regulating these areas shares a common denominator — the ample evidence that, due to the presence of market failures, the market is unable to render satisfactory outcomes as cost-effectively without regulation, provided it is designed and administered properly.[88] These areas are discussed in greater detail below, along with price regulation, since this is an area of particular concern.

Before turning to these areas, the distinction between extensive regulation and effective regulation bears emphasizing. As noted above, nearly every aspect of conducting insurance transactions is subject to some degree of regulatory scrutiny and control in the United States. There are increasing indications, however, that efforts to regulate so extensively may come at the expense of the ability to regulate effectively. Since regulatory resources are limited, as the number of aspects subject to regulatory control and scrutiny increases, the degree and quality of such control and scrutiny over the most critical elements of regulation necessarily must decrease. At the same time, the insurance market continues to expand and become more complex, which has further strained regulatory capacity.

Consequently, the state system is sometimes criticized for being overly broad but insufficiently exacting. Certainly, the findings of the GAO in its past investigations have tended to underscore the notion that by trying to do too much and without sufficient coordination, state insurance regulators do not always carry out their core functions effectively. More recently, industry observers have pointed to questionable regulatory performance in light of the Frankel fraud case, the insolvency of Reliance Insurance Company

87 See Grace and Klein (1999) at 9-14.

88 In contrast, there is considerably more debate in a third area of intervention — ensuring fair prices (both to insurers and consumers) — where regulation increasingly is considered to achieve less satisfactory outcomes at a higher cost than the market otherwise would achieve. While rate regulation is often categorized within the area of financial risk or consumer protection, it is discussed separately here as a special case.

and the emerging crisis in the property market following the terrorist attacks last year. While few, if anyone, anticipated the terrorist attacks, the other two incidents certainly fall within the bounds of routine regulatory matters that were not adequately prevented or controlled by regulators. Thus, questions concerning the regulators' ability to administer their core functions effectively in the context of new markets, new market participants and new products are reasonable and justified. It should be recognized that the failure or inability of the state-based system to provide reassurances or answers to these questions has led to uncertainty and concerns that, in turn, have led to calls for changes to the regulatory structure.

1. SOLVENCY AND LIMITING FINANCIAL RISK

Information constraints and principal-agent conflicts create inefficiencies in the market that tend to manifest themselves in excessive insolvency costs.[89] For regulation to be effective in this area, it must, at the very minimum, reduce the number of insolvencies and the corresponding losses that would otherwise occur without regulation. This can be achieved through both prevention and timely intervention. Yet, a mere reduction in insolvencies or insolvency losses and related impacts (including those borne outside the insurance market) is not sufficient to justify regulation unless such benefits *exceed* the costs of such regulation. While this is likely to be the case due to the high potential costs and related impacts of insolvencies, it should not be presumed since the regulations themselves engender risks, costs and distortions that potentially undermine insurer solvency.

While there is general agreement on the merit of regulating insurer financial condition, there is much less agreement on the extent and manner in which such regulation should be conducted. The primary elements of a sound regulatory system of financial risk include: 1) maintenance of adequate solvency margins; 2) monitoring of insurer financial conditions including minimum capital and surplus standards; and, 3) early intervention to forestall collapses or minimize the impacts from high-risk or otherwise troubled insurers.[90]

Due to the sensitive nature of the full complement of data considered necessary to evaluate individual company solvency, state regulators, company actuaries and accountants are the key players in achieving effective oversight by virtue of their access to such data. Mandated disclosures provide additional, albeit more limited, avenues of oversight by other market participants. Nevertheless, there is ample evidence that the disclosure of solvency-related information is not sufficient by itself to enable early intervention against troubled insurers. None of the public and private parties involved, including regulators (domiciliary and other), direct market participants, industry and security analysts, company auditors and private ratings bureaus, has an admirable track record in anticipating insolvencies before they occur.[91]

In significant part, this is due to the generally overarching impact of actual versus expected loss costs on insurer financial performance and condition. Certainly, all other elements of an insurer's financial results — underwriting conditions (premium prices and volumes), investment returns and expense ratios — play an important role, but far less so than loss costs, especially in the short-term.[92] Unanticipated and sudden changes in claims frequency and loss severity or experience are usually prime factors

89 See Grace and Klein (1999) at 8-9; Munch and Smallwood (1981). Here, excessive insolvencies do not refer to a specific number, either on an absolute basis or in relation to any baseline. "Excessive" in this context refers to the costs of the insolvencies that might occur in an unregulated market versus those that might occur in a regulated market.

90 See Grace and Klein (1999) at 11.

91 This common criticism highlights the fact that regulators are less frequently given credit for events that do not occur, i.e., preventing insolvencies by identifying troubled insurers and intervening. Regulators have claimed 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. See Klein (2000) at 55. Moreover, while both state banking and insurance regulators have struggled at times with insolvencies, federal regulators have not proven to be clearly superior in this regard in the banking and securities industries. See Macey and Miller (1993) at 92, 94.

92 See Harrington (1991). In a ten-year analysis of insurer costs in automobile and homeowners lines, loss costs accounted for 81 percent of each premium dollar. In contrast, expenses and commissions comprised 24 percent of each premium dollar, while pre-tax profits and dividends to shareholders combined comprised only 1.5 percent of each premium dollar. See Harrington (2000-2) at 37-38. As noted previously, the property/casualty segment has suffered persistent underwriting losses over the last decade, meaning that loss costs have exceeded premium income in each year, sometimes by significant margins.

in insolvencies, particularly in property-casualty lines.[93] Even rigorous monitoring and the adoption of conservative solvency margins often prove to be insufficient regulatory tools given the vagaries of actual loss costs.[94] The property/casualty segment's experience is illustrative since its insolvency costs have tended to correlate closely with underwriting losses. In fact, the relationship between underwriting losses and insolvency costs is so clear that it is difficult to discern whether regulatory oversight contributes meaningfully to improved solvency performance, or whether such improvement is more a function of improved loss experience, over which regulators have little direct control.

Since 1969, as a fall back to oversight, state guaranty associations have provided a generally well-received mechanism for recapturing and internalizing the costs of insolvencies, and, most importantly, serving as a backstop for market confidence. Administration of receiverships is also an important, if less well-received, regulatory tool that is designed to preserve assets and minimize adverse impacts on the insurance market as a whole. Nevertheless, these measures are subject to their own limitations and inherent weaknesses that undermine their positive contributions.

Guaranty associations introduce distortions in the market by interfering with normal risk-reward dynamics. This interference can produce a "moral hazard" problem by essentially promoting increased risk-taking by insurers and indifference by consumers, since the presence of the guaranty fund protection reduces market concern about such risk-taking.[95] Thus, rather than serve to limit insurer financial risk (the explicit goal of solvency regulation), guaranty associations can, in practice, foster risk-taking while imposing additional costs on the market, thereby exacerbating the problem. While there are a number of mechanisms to offset moral hazard problems, they relate to the particulars of solvency regulation rather than to the structure of regulation.[96]

Regulatory structure plays a key role in continuing issues regarding the limited capacity of individual, state-run guaranty funds and other weaknesses in the coordination of solvency oversight among the states. In large part, this is due to the ability of states effectively to force other states to bear the costs of their lax oversight of companies in their domicile. Because insolvency costs are shared among all the states in which a company does business, when domiciled companies write a relatively small amount of their overall premiums in-state, the other states in which it is active will be primarily responsible for any insolvency costs associated with those companies. This inconsistency sets up a conflict for state regulators, whose interest in the survival of their domiciled companies will be greater than their liability in any subsequent insolvencies. Understandably, this produces a tendency toward greater forbearance and delay

93 These factors are also referred to more generally (and critically) as deficient loss reserves. Other important determinants frequently cited include inadequate rates, fraud and misappropriation of insurer assets, accounting misstatements, reinsurance failures, excessive premium growth, capital losses in investment portfolios, financial pressures from affiliates and general mismanagement. See Klein (2000) at 39-40; Harrington (1991).

94 See, generally, Macey and Miller (1993). The same is not true with respect to fraud, misappropriation and excessive growth. On the other hand, Congress has focused repeatedly on the industry's solvency problems, citing numerous and persistent examples of ineffective solvency oversight by state regulators as prime factors. State regulators have been quick to respond by undertaking reforms and other actions to avert direct federal involvement. Nevertheless, past insolvencies have raised the question of whether regulators can identify company-specific problems, such as aggressive pricing and the understatement of reserves, on a reliable and sufficiently early basis. See Harrington (1991). The insolvency and liquidation of Reliance Insurance Company in 2001 caused these concerns to resurface given that the company's problems developed over a period of years, yet met with forbearance from Pennsylvania regulators until the company finally declared bankruptcy and was forced into liquidation. The reasons cited for the company's failure include excessive premium growth, reserve inadequacy, capital depletion, excessive debt, and risky portfolio investments, all of which were evident for a number of years and were subject to regular regulatory review. The failure is expected to be the costliest insurance insolvency in history. See van Aartrijk, Peter, Jr. "Saul Steinberg and the Reliance Debacle." *Insurance Journal*, May 11, 2001.

95 This is particularly evident for companies that are insolvent or threatened with imminent insolvency. A recent study asserts that guaranty funds often provide cover to troubled insurers by permitting them to engage in excessive premium writing as a means of effectively borrowing funds from policyholders at rates that do not reflect their riskiness. As evidence, the study found that a significant proportion of insolvent property-casualty insurers tended to have rapid growth in premiums shortly before failing and that this growth was concentrated in long-tail lines (for which there is a greater lag between premium payments and loss claims). This was a prime factor cited in the failure Reliance Insurance Company. Significantly, the study also found that states that committed greater resources to solvency regulation were less vulnerable to this exploitation. See Bohn, James G. and Brian J. Hall. "The Costs of Insurance Company Failures." *The Economics of Property-Casualty Insurance*. Edited by David F. Bradford, Chicago: The University of Chicago Press, 1998, pp. 139-166.

96 See Grace and Klein (1999) at 12; Klein (2000) at 59. These mechanisms include risk-based and ex-ante assessments, cost-sharing through larger deductibles and co-insurance provisions.

in intervention that ultimately can increase the costs of the insolvencies that nevertheless occur.[97]

Due to these inherent structural limitations in state solvency regulation, proposals for federal involvement in this area have been put forward, including, with variations, replacing the individual state guaranty funds with a single federal fund. There are additional concerns whether state regulators have sufficient regulatory reach and expertise to oversee companies that are operating primarily in other states, not to mention other countries. While federal solvency oversight has the potential to overcome these structural limitations, there are two primary drawbacks to these proposals.

First, from the perspective of scope and effectiveness, there is no evidence that federal solvency oversight would perform better than state oversight; to the contrary, there is significant evidence that federal oversight could be less effective based on its historical track record. On the other hand, solvency oversight has never required as much national and international range as it does today, and there are legitimate questions whether individual state regulators can adequately cover that range.

Second, from the perspective of structure, while a federal solution can overcome the specific limitations identified in the state structure, it can also introduce new structural problems depending on how the solution is implemented. In particular, some of the proposals have called for transfer of solvency oversight to the federal government, while the states retain responsibility for all or part of market conduct regulation. As discussed previously, given the close relationship of solvency and market conduct regulation, separating these two responsibilities between the federal and state governments could create harmful conflicts with perverse market consequences.[98] As a result, a structure that involves shared responsibility between the states and federal government with regard to these discrete areas of oversight could be inherently unstable, unworkable or simply inefficient. Such a structure would likely generate pressures for greater federal involvement or a return to primarily state-based oversight.[99]

The administration of receiverships has also been criticized widely due to its perceived high direct costs which run counter to its express goal of preserving assets. Once again, since jurisdictional conflicts and the high potential for negative externalities among states warrant regulatory intervention in administering receiverships in the first place, the structure of regulation plays a key role in its efficiency. Certainly the combination of domiciliary state forbearance and excessive risk-taking by troubled insurers tends to drive insolvency costs higher. Studies have suggested, however, that insurance industry insolvency costs may be *several times* higher than necessary, due in part to administrative frictions such as a lack of expertise or capacity, and redundancy.[100] As a result, there have been calls for greater state coordination and even federal involvement, particularly for insolvencies involving multi-state insurers. Several states pushed forward on earlier efforts by the National Council of Insurance Legislators ("NCOIL") to address redundancies and capacity issues in administering receiverships via interstate compacts. That effort,

97 This tendency has been a chief finding of federal investigations on insurance industry insolvencies. See U.S. General Accounting Office (1991); U.S. House of Representatives (1990); Macey and Miller (1993) at 91-92. Domiciliary state forbearance (by Pennsylvania) has been cited as a factor in the insolvency of Reliance, the costs of which are being borne primarily by other states, particularly those with the largest markets (California, New York and Texas). See "Louisiana Insurance Guaranty Association Looks at Losses of $175 Million." *Insurance Journal, Regional News — South*, October 9, 2001.

98 For example, if states retained authority over rate regulation without direct responsibility for solvency, they might be prone to suppressing rates for socio-political reasons but to the detriment of insurer solvency. Since the states would not be responsible for solvency, such behavior would externalize risks and costs onto other states and the federal government. See Macey and Miller (1993) at 92-95. As noted below, the autonomous nature of solvency and market conduct regulation *within* a single state agency has been cause for concern. Separating these functions, in whole or in part, between federal and state agencies should, therefore, be cause for even greater concern.

99 IBID.

100 See Klein (2000) at 59 and Grace and Klein (1999) at 34, citing Bohn, James G. and Brian J. Hall, 1995, *Property and Casualty Solvency Funds as a Tax and Social Insurance System*, NBER Working Paper 5206. This study concluded that insurance company insolvencies were three times as costly as bank insolvencies in terms of pre-insolvency assets. While this is a compelling finding, it should not be considered definitive for several reasons. First, given the significant differences in the assets and liabilities between banks and insurance companies (e.g., risk profiles and maturities, liquidity, capital and reserve standards, investment restrictions, federal guaranty), there is no reason to expect that insolvency costs should be comparable if measured in terms of assets. See Macey and Miller (1993) at 79-81. Second, this comparison ignores differences in the "quality" of receivership administration, which would be reflected in the ratio between unfunded costs and pre-insolvency assets. In other words, if unfunded costs are reduced sufficiently, then a higher level of expenditures may be warranted or justified. The "quality" issue could be significant given that insurer solvency oversight has been more effective than bank solvency oversight in terms of the number and total size of insolvencies experienced. See Macey and Miller (1993) at 92.

however, was limited to a handful of states and has since lost momentum due to sovereignty concerns and a lack of uniformity in underlying regulations.

2. CONSUMER PROTECTIONS AND POLICING MARKET CONDUCT

This broad area of intervention includes the following aspects of insurers' activities: prices (discussed separately below), policy forms, marketing, underwriting, policy terminations, claims handling and complaint resolution.[101]

Once again, information constraints and principal-agent conflicts are the primary justifications for intervention in this area. Without intervention, the market would tend toward generating gaps in coverage, noncompliance with mandatory coverages, and disputes that would tend to favor insurers over consumers due to their significant advantages in proficiency and market power.[102] While regulatory intervention can increase consumer protections and constrain deceptive or bad faith practices by insurers, many believe that such intervention is far in excess of the level actually needed to achieve the desired outcomes.[103] Excessive intervention imposes costs that greatly exceed the benefits to consumers and thus, actually reduces consumer protections, largely by putting upward pressure on prices, limiting choices and distorting normal risk-reward relationships.

Complaints that market conduct regulation exceeds the level necessary for consumer protection is a more a matter of regulatory scope than structure. In contrast, regulation in this area tends to be driven by unique state requirements or, even worse, socio-political goals that tend to be divorced from concerns regarding overall market efficiency. Consequently, market conduct is a prime area of regulation where non-uniform rules and regulations beget non-uniform or autonomous oversight, leading to redundancies that do not necessarily contribute to better oversight. For insurers, this potentially means multiple examinations across jurisdictions with varying standards in any given year. As such, the structure of regulation can potentially play an important role in achieving improved outcomes in this area.

The independence of financial and market conduct oversight within regulatory agencies is another structural concern. Prior to the 1970s, market conduct regulation generally was performed as an adjunct to financial regulation. In recognition of the increasing importance of market conduct regulation, NAIC developed a market conduct examination handbook that sought to help states achieve certain minimum standards in their oversight of these areas. While NAIC's efforts were successful in improving the quality of oversight, they also greatly expanded the scope of market conduct regulation to the point where it has become a near-equal pillar to financial oversight. Unfortunately, as market conduct regulation has expanded, it also has tended to diverge and become more independent of financial oversight. As monitoring and oversight in these areas became more discrete, problems invariably ensued as compliance and enforcement in one area tended to impact the other area, due to the often symbiotic relationship between market conduct and financial regulation. More recently, these discrete regulatory units have begun to cooperate more closely in order to avoid causing or transferring problems between these areas.[104]

While the regulation of policy forms (standardization and minimum coverages), risk classification (avoiding unfair discrimination),[105] and general market conduct provides undeniable benefits to the market, the actual degree of regulation likely exceeds that which is necessary to mitigate true market failures in this area,[106] which typically are limited to information constraints and principal-agent conflicts. As reg-

101 See Grace and Klein (1999) at 10.

102 IBID.

103 See Grace and Klein (1999) at 13; Klein (2000) at 52-53.

104 See Klein (2000) at 52.

105 Rate classification restrictions can have a much greater effect on prices than direct rate regulation, which is discussed next.

106 See Harrington (2000-2) at 37-38.

ulation expands beyond this minimally necessary point, it begins to encroach upon otherwise competitive and efficient market functioning, to the detriment of both insurers and consumers. While such expanded regulation continues to generate benefits for the market, it does so at much greater costs that reduces overall welfare.[107] These costs are both direct and indirect in nature. While the direct costs — compliance and enforcement — may be significant by themselves, the significant distortions and other indirect costs that such intervention can introduce are of greater concern, particularly when the intervention is driven primarily by non-market objectives that go well beyond simple consumer protection.

3. PRICE/RATE REGULATION

The traditional rationale for price regulation in any market is to prevent excess profits and welfare losses due to excessive market power of suppliers. While this rationale is applicable to the insurance industry, price regulation of insurance contracts has also been driven by *converse* concerns that inadequate pricing and excessive competition would lead to instability and insolvencies in the market. While recognizing that different segments of the market are subject to different dynamics, as a whole it is difficult to reconcile the coincident threat of *both* excessive *and* inadequate prices, since one should preclude the other from a structural standpoint. These contradictory rationales are discussed separately below.

The historical development of the industry has played an important role in the industry's price regulation, particularly its reliance on rating bureaus and, more recently, on rate advisory organizations. The passage of the McCarran-Ferguson Act spurred states to regulate rating bureau activities, primarily in order to avoid federal antitrust oversight. Since then, price regulation has strayed from its two traditional rationales (limiting excessive and inadequate prices) toward addressing affordability concerns more generally, particularly for compulsory coverages.[108] Regulated affordability is a structurally unsound and unsustainable objective that introduces numerous distortions into the market and ultimately increases rather than mitigates the risk of market failures. History has provided ample evidence of the inefficiency, and often the folly, of strict price controls, especially in otherwise competitive markets.

From a structural standpoint, the combination of mandated coverages and regulated prices can be fertile ground, once again, for the pursuit of social and political objectives that are divorced from market efficiency concerns (and ultimately the best interests of the consumers).[109] Some proponents of change in the regulatory structure believe that the state system exhibits a greater bias toward these non-market objectives than would, for example, a federal structure.[110] This possibility is indeterminate, however, and does not preclude an alternative outcome in which a federal structure could be even more distorting. The very strong restrictions imposed by Congress on health care insurers provide some substantiation for this contention.[111] On the other hand, an optional federal charter may be a more effective approach in this regard, since the ability of companies to move between state and federal charters could create competitive regulatory pressures that help reduce or limit the pursuit of social and political objectives by either state or federal regulators.

107 The fact that expanding intervention produces benefits, therefore, is not sufficient justification unless the incremental benefits exceed their corresponding costs. Since the incremental costs expand quickly once regulation exceeds the level necessary to mitigate only the extent of true market failures, such regulation can be costly, and, ultimately, counterproductive.

108 The justifications for comparatively strict regulation of compulsory coverages are both economic and social. The compulsory nature of coverage is thought to make demand inelastic and thus provide greater pricing leverage to suppliers. While this is a reasonable theory, there is little evidence to support this in the market generally, and no theoretical basis for inelastic demand to have an impact on prices in the long-run, provided there is sufficient competition among suppliers. See Harrington (2000-2) at 27-28. The social justification stems from the notion that coverages that are mandated must also be made affordable. Regulation would likely be more effective in countering the forces of inelastic demand and promoting affordability by ensuring adequate supply. Strict price regulation and suppression are inconsistent with that outcome and tend to limit rather than expand supply, thereby putting upward pressure on prices.

109 The states' frequent mandating of rate decreases in the face of demonstrably rising loss costs is difficult to rationalize except on socio-political grounds.

110 See Grace and Klein (1999) at 8.

111 IBID.

Competitive Deregulation

Not surprisingly, the effort to deregulate generally, but especially on commercial lines, is being spurred by smaller market states seeking to improve the attractiveness of their markets vis-à-vis other states that have the luxury of larger markets. In the past, the effects of differential deregulatory efforts on relative market competitiveness and attractiveness among the states provided much-needed impetus to achieve wider reform in the banking sector.

The same potential clearly exists in the insurance industry. The widespread use of retaliatory taxes and fees, which penalize companies operating in states where such taxes and fees are relatively high, provides a good example.

Late last year, the state of Georgia's largest insurer – AFLAC – redomesticated to Nebraska due to high premium taxes (2.25 percent in Georgia versus 1.0 percent in Nebraska). Over the last decade alone, 10 companies have redomesticated from Georgia. The large carriers that have remained write most of their business in-state.

More constructively, the state of Indiana sharply reduced its premium tax from 2.0 percent to 1.3 percent last year. This action brought Indiana's rate in line with other states in the region, made its market more attractive as a domicile, and reduced the retaliatory taxes faced by its domiciled insurers.

See "Renaissance Regulators." Best's Review, June, 2000. "Georgia Commissioner Complains About Taxes." Insurance Journal – Property and Casualty Magazine, December 10, 2001; "Indiana Premium Tax Veto Overridden; Lower Tax Rate Takes Effect." Insurance Journal – Property and Casualty Magazine, January 24, 2001.

More recently, rate regulation has been relaxed, initially by a movement away from strict prior approval laws and then toward wholesale deregulation of commercial lines for large companies. The sporadic and limited nature of such deregulatory efforts, however, has caused a wide variation in both supply and price across different state markets despite their structurally competitive nature. These price variations provide clearer empirical evidence of the generally harmful effects of price regulation since they appear to be as attributable to differential oversight as they are to underlying market fundamentals. Rather than complementing market forces, regulation essentially has supplanted them.

Another important indicator of excessive regulatory interference is the size of nonstandard (residual, alternative, excess and surplus) markets relative to traditional markets (standard and voluntary). Rapid growth in and size of nonstandard markets is not a desirable outcome if it occurs in response to restrictive regulation, particularly of prices, and results in avoidance of regulatory oversight rather than an overt decision not to regulate.

In sum, it is evident that socio-political influences in rate regulation are harmful to market functioning, regardless of their particular objectives. As discussed further below, the soundness of even the traditional and accepted rationales for price regulation is disputable in practice.

A. FIRM MARKET POWER RATIONALE

There are numerous studies and abundant evidence that the first rationale for regulating prices — the existence of firm market power and excessive prices — is not applicable to the insurance market.[112] This lack of market power is evident across a number of parameters and criteria — *absent regulatory constraints on rates and forms* — including insurer profitability and market concentration, as well as the degree of heterogeneity among products, service levels, prices and underwriting standards.[113] As noted earlier, the bulk of the evidence points to competitively structured markets, with little or no evidence of insurer market power, let alone excessive prices or underwriting profits. In fact, it has been written that insurance is the only major industry in the United States that is both highly unconcentrated — with almost all markets served by a large number of firms with none having sufficient market share to exert market power — and yet still subject to price controls in many states.[114]

With little evidence of an underlying market failure stemming from firm market power, there is considerably less theoretical support for price regulation, except as a means of promoting social objectives. Predictably, the regulation of prices in the absence of the fundamental preconditions of market failure leads to numerous distortions and regulatory costs that likely far exceed any intended benefits, whether economic or social. Most damaging in this respect, is the tendency of price regulation to sever the crucial link between premiums and expected losses, thereby diminishing the incentives for loss control and causing overall losses to increase.[115]

Even if the insurance market were predisposed toward undesirable levels of firm market power, that failure must manifest itself adversely to justify regulation of prices, otherwise the regulation merely imposes incremental costs and reduces overall welfare.[116] Presumably, the chief consequence of firm market power is most properly measured by profitability rather than prices per se.[117] Even if profits were a meaningful indicator of firm market power, there is no clear evidence of excessive profitability in the industry.[118] By extension, if profitability is not excessive under normal business conditions (or warranted due to superior performance), then it is likely that price regulation is not only unnecessary, but counterproductive. Nevertheless, simply measuring profitability of insurers in a regulatory context can be a complex undertaking for several reasons, as follows:[119]

- Investment and portfolio earnings can be a critical determinant of insurer profitability and are not directly tied to premium rates;

112 See Grace and Klein (1999) at 8; see also, more generally, Macey and Miller (1993); MacAvoy, Paul W., ed. 1977. *Federal-State Regulation of the Pricing and Marketing of Insurance*. Washington, D.C.: American Enterprise Institute; Danzon, Patricia M., 1983. "Rating Bureaus in U.S. Property-Liability Insurance Markets: Anti- or Pro-Competitive?" *Geneva Papers on Risk and Insurance* 8: 371-402; Joskow, Paul L., and Linda McLaughlin, 1991. "McCarran-Ferguson Act Reform: More Competition or More Regulation?" *Journal of Risk and Uncertainty* 4: 373-401.

113 See Harrington (2000-2) at 25-26.

114 See Macey and Miller (1993) at 99.

115 See Harrington (2000-2) at 34. These and other distortional costs are discussed further in the next section.

116 NAIC estimates that the annual *direct* costs of property and casualty *rate* regulation are $40-55 million for the state regulators and in excess of $1 billion for the industry. Moreover, these costs are increasing despite efforts to deregulate. See NAIC (1998) at 5.

117 Few firms benefit from higher prices per se, especially in industries with significant economies of scale and a large number of suppliers, as is typically the case with insurance. Economies of scale act to curb unjustifiably high prices by encouraging increased output that, in a market with a large number of suppliers, produces strong competition and a downward bias to prices (ceteris paribus). Most companies, particularly those in developed or mature markets such as insurance, are more concerned with profits rather than revenues. One notable exception is the anomaly of "reverse competition," where insurers may seek to increase or maintain premium levels and, thus, commissions and other allowances paid to brokers, as consideration for business placement. This is a relatively isolated occurrence in the insurance market (limited to credit and title insurance) that seems to receive an excessive amount of attention, especially in the context of supporting broad price regulation. See Feldhaus and Klein (1998) at 68.

118 See Harrington (2000-2) at 19-20; Feldhaus and Klein (1998) at 38.

119 IBID.

- The market values of portfolio holdings can be difficult to assess due to uncertainties related to their current values, and are subject to change, sometimes rapidly or unpredictably;

- Underwriting results are often subject to substantial fluctuations from one year to the next, almost always due to fluctuations in loss costs; and,

- From a regulatory perspective, profitability must be assessed by product line and/or state.

The last point is particularly vexing given the difficulties with measuring overall profitability. Segmenting insurer profitability by product lines or geographical areas is considerably more complicated and potentially arbitrary. As an initial matter, there is no clear basis by which investment income, capital and expenses can be segmented by product lines or geographical areas. Geographical limitations underscore one of the primary weaknesses of the state structure — that relevant determinations often must be made on a state-by-state basis. The fundamental question is whether such state-specific analyses are meaningful in an increasingly national and international market.[120]

Even if profitability could be accurately measured as needed, the determination of an acceptable level of profitability can be arbitrary. If it were based on average or peer levels of profitability, such price regulation would constrain efficient and more profitable insurers more than inefficient and less profitable ones. The effect of such regulation is to dampen the market's otherwise efficient allocations, which clearly fails the test of effective intervention. Unlike geographical limitations, however, the reliance on such benchmarks is a weakness in the scope of regulation rather than characteristic of the state system.

Even the absence of excessive profitability, which normally is dispositive of an absence of market power, is insufficient in practice to preclude price regulation in insurance markets. Presumably, the reasoning is that insurers with market power might not achieve excessive profits if they operate inefficiently with high expense levels (presumably enabled in part by the absence of competition).[121] Thus, when actual profit experience fails to sustain the need for price regulation, insurer expenses and accounting practices often provide alternative grounds for scrutiny.

Any regulation tied to insurer expenses (and presumably firm efficiency) tends to be inherently flawed due to the relative insignificance of operating expenses vis-à-vis loss costs for insurers. Depending on the particular line, loss costs including adjustment expenses typically account for 70 percent or more of total costs (and frequently exceed premium income), thus providing much more fertile ground than expenses (or profits for that matter) for achieving reductions in premiums.[122] Consequently, even if significant reductions could be achieved in insurer expenses or profits, the impact on premiums would still be relatively small than if similar attention were focused on loss costs. Nevertheless, insurer expenses, as a purported driver of premium levels, frequently are deemed to warrant close regulatory attention. At a minimum, this is misdirected. At worst, by interfering with the market's normal allocative function and distorting the incentives for loss control, price regulation focuses on a problem for which there is little evidence in the market, and, therefore tends to impose far greater costs than it yields apparent benefits.

120 IBID. NAIC's model competitive rating law requires a finding that competition is failing in a given market, based on explicit indicators, as a prerequisite to regulatory intervention via rate restrictions. On one hand, this is a step in the right direction since it provides relatively uniform and objective guidance regarding the conditions necessary to justify such intervention. On the other hand, given the difficulties and limitations in making such determinations in the first place, the potential exists that competitive rating laws simply codify a practice that, to some extent, is based on unsound fundamentals or potentially arbitrary judgments.

121 This rationale suggests that firms will use their market power to raise prices not necessarily to increase profits, but more to have the freedom to operate inefficiently. There is no evidence to support this theory in the insurance market. Alternatively, insurers are accused of understating profits by various methods, including the overstatement of loss costs. Even if true or relevant, such problems are more properly and efficiently addressed through accounting standards and financial oversight than through market conduct and price regulation.

122 IBID at 36-38.

B. MARKET INSTABILITY

There also is little or no evidence that the second rationale for price regulation — market instability and insolvencies — is applicable to the insurance market. For the same reasons noted above, recent episodes of instability and insolvencies primarily have been linked to unanticipated increases in loss severity and frequency. While other factors such as portfolio losses, fraud and unrestrained growth have also contributed, price *suppression* due to excessive competition is not readily apparent.[123]

While it might be argued that the type of excessive premium growth that often leads to insolvencies is facilitated by price suppression by competing firms, two distinctions must be made. First, the achievement of rapid premium growth by an individual insurer is indicative of an *absence* of market-wide destructive competition, which, in contrast, is characterized by a collective "race to the bottom" in defense of market share. In the latter case, market shares would not be expected to change as dramatically and premium volume would decrease rather than increase as average rates declined sharply. The fact that an individual company is able to gain market share rapidly requires that the rest of the market refuses to respond in kind. Second, the role that guaranty fund protections play in enabling this type of behavior should be considered, rather than focusing merely on restricting the behavior by imposing broad rate restrictions.

If the market evidenced tendencies toward overly competitive behavior and price suppression, the question again is whether that constitutes a market failure in the first place, and whether price regulation constitutes an effective response. While there is scant evidence that the market is prone to destructive price competition, there are other regulatory tools in place — financial and solvency monitoring in particular — that have proven comparatively effective in maintaining market stability and minimizing insolvencies. Consequently, it is disputable whether further intervention via price regulation is needed or whether it even makes a net positive contribution toward its objectives of market stability and firm solvency.[124]

C. SUMMARY

Regulation would tend to be far more effective if it sought to tighten the link between premiums and expected costs rather than undermine that link by focusing unduly on premiums. Understandably, the tendency toward regulatory rate suppression is often strongest when rapid and widespread increases in claim costs lead to competitive increases in premium rates,[125] which is contrary to normal market signaling. Any improvement in "affordability" stemming from regulated price suppression is only short-lived and tends to produce far greater costs in terms of reduced supply, market instability and deterioration in overall solvency.[126]

Similarly, the fact that certain insurers may engage in excessive premium writing (presumably via under-market pricing) has not given rise to widespread destructive competition. To the contrary, these insurers have tended to fail, which is evidence of proper market functioning. To the extent that these failures are undesirable from a regulatory perspective, other tools such as ongoing solvency monitoring provide regulators with a far more efficient means of controlling such isolated incidents, as opposed to subjecting the entire market to price regulation. Consequently, given the largely adverse market consequences as well as the high direct and indirect costs of price regulation, the deregulation of prices should be considered an important factor in the evaluation of alternative regulatory structures.

123 See Macey and Miller (1993) at 109, citing Joskow (1973) at 375, 423; Harrington (2000-2) at 25. Rather than insolvencies and instability, the ramifications of strong competition in the market seem to be consolidation, especially in property-casualty lines for both underwriters and intermediaries. Arguably, consolidation increases firm market power although there is little or no evidence of that to date. See Klein (2000) at 5-6.

124 In contrast, there is significant evidence that excessive rate regulation can lead to greater instability in the market. The restrictive nature of certain states' rate regulation can produce such uncertainty that it is reflected directly in private ratings for firms with significant exposures in such states. See Macey and Miller (1993) at 103.

125 See Harrington (2000-2) at 8-10, 13, 35; Grace and Klein (1999) at 12.

126 See Harrington (2000-2) at 11, 37-38.

VII Types of Regulatory Costs

Regulation imposes three primary types of costs relevant to this study:

- Direct expenditures by regulators;
- Direct compliance costs incurred by the industry; and,
- Indirect costs on market efficiency.

Understandably, assessments of regulatory efficiency and effectiveness tend to focus on *direct expenditures by regulators* and *direct compliance costs incurred by the industry* because they are tangible and, therefore, most readily analyzed. The third type — *indirect costs on market efficiency* — is likely far greater than the other two both in absolute terms as well as its impact on overall market efficiency. Nevertheless, these indirect costs often fail to receive sufficient attention largely because they are intangible and, therefore, difficult to analyze. A clear understanding of both the explicit and implicit costs of regulation, however, is critical to an accurate assessment of the relative costs and benefits of alternative regulatory structures.

Due to the complexities of measuring these costs, it is challenging even to conclude whether they have been increasing, decreasing or remaining stable, though it is clear they are substantial. Regardless of their trend, changes in the industry's competitive operating environment have increased sensitivity to these costs, whether direct (i.e., expenditures by government and industry) or indirect (e.g., delays) in nature. The operating environment is being transformed by the convergence of financial services, electronic commerce and globalization, all of which have sharpened competitive forces. Under these conditions, the costs of regulation are magnified, particularly given their potential to produce significant disadvantages vis-à-vis new domestic and foreign competitors (or products) that are not subject to the same regulatory constraints.[127] While this applies to the costs of even minimally necessary regulation, it is most relevant in the case of regulatory constraints that impose significant burdens and inefficiencies without attendant benefits or even suitable underlying rationales. In the past, excessive regulatory burdens were more tolerable when they tended to impact insurers equally or without discrimination. While they still present the same handicaps, they now have the potential to threaten the industry's ability to compete and thrive against new or restructured competitors that may not face the same restrictions and costs.

A. DIRECT GOVERNMENTAL EXPENDITURES

Direct governmental expenditures are the most obvious and measurable of the three costs of regulation; they are also the least significant.[128] Like other types of governmental spending, direct regulatory expenditures tend to attract greater scrutiny and understanding than their downstream economic impacts on markets and industries, even though the latter have much greater and potentially hazardous consequences.

127 See ACLI (1999) at II-15; Liberty Mutual (2001) at 1-2, 6, 13; Klein (2000) at 66.

128 See Grace and Klein (1999) at 23.

The relative certainty of these expenditures makes them easiest to summarize and discuss, although analyzing them under alternative regulatory structures still remains a complex endeavor.[129]

1. BASIC FACTS[130]

Total revenues — total revenues collected by the states from the insurance industry totaled $10.2 billion in 1999. The majority of these funds came from three sources, in declining order of importance:

- Business and income taxes (premium, retaliatory and other);[131]
- Fees for regulatory services and other assessments; and,
- Fines and penalties.

Size of state budgets — annual insurance department budgets vary dramatically by state, ranging from slightly more than $1 million (South Carolina) to over $125 million (California).[132] Total state insurance department budgets were $880 million in 2000 and expected to reach $910 million in 2001.

Size of NAIC's budget — the association's budget was $46.9 million in 2001 and 49.8 million in 2002.[133] Expenditures by NAIC complement or facilitate the states' expenditures. The sources of its revenues include, in declining order of importance:[134]

- Fees paid by insurers (voluntary and based on premiums);
- Fees for publications, database products and meetings; and,
- Insurance department member fees.[135]

2. IMPLICATIONS FOR THE INDUSTRY

For purposes of this analysis, total direct regulatory expenditures are estimated at roughly $900 million in 2000.[136] While these direct expenditures are substantial in absolute terms, they are quite modest both in relation to the industry's annual premiums and total revenues collected from the industry by the states. Total direct regulatory expenditures equal 0.1 percent or less of total industry premiums (roughly $900 billion in 1999 and an estimated $970 billion in 2000),[137] indicating that even if such expenditures were eliminated completely, the direct effect on premiums would be minuscule. Thus, substantial

129 While there are detailed and comprehensive data available on *state* regulatory expenditures through NAIC, which conducts an annual survey, similar data on *federal* regulatory expenditures, which are increasing and significant, are not readily available. Examples of federal regulatory expenditures include federal insurance programs (crop and flood insurance), setting of national standards to be enforced or implemented by the states (loss ratio standards for Medicare supplements) or actions otherwise limiting state regulatory control (risk retention groups, employer-funded health plans and, more generally, Congressional oversight). In addition, other general federal regulatory activities have an important bearing on the insurance industry's regulation (antitrust, international trade, law enforcement, taxation and the regulation of other financial services industries). See Grace and Klein (1999) at 17.

130 See NAIC, *2000 Insurance Department Resources Report*, (reporting 1999 data) unless otherwise noted. Data for 2000 were not yet available.

131 Excludes federal income taxes, which are more substantial. In 1998, property and casualty insurers paid an estimated $6.7 billion in federal income taxes (according to the Insurance Information Institute), while life insurers paid $13.3 billion (according to the American Council of Life Insurance).

132 See Grace and Klein (1999) at 24.

133 See "NAIC Subcommittee Approves 2001 Budget," *NAIC News Release*, November 6, 2000; "NAIC Members Approve 2002 Budget," *NAIC News*, December 2001.

134 See Grace and Klein (1999) at 20.

135 Also included within state regulatory expenditures.

136 This figure equals the total of the state budgets ($880 million) plus approximately half of NAIC's budget ($46.9 million). Only a portion of NAIC's budget is included because insurance department member fees already are included in the state budget amounts and otherwise would be double-counted.

137 Estimate reflects the application of the growth rate in total premiums between 1999 and 2000 reported by Swiss Re (8.3 percent) to the total premiums reported by NAIC in 1999.

increases or decreases in direct regulatory expenditures by the states are unlikely to affect premiums significantly through *direct* cost savings.

Direct regulatory expenditures accounted for only 8.8 percent of the $10.2 billion in revenues collected from the industry in 1999. In other words, less than 9 cents of every dollar collected from the insurance industry by the states are dedicated to insurance regulation, with most directed instead to state treasuries. Despite the relatively low ratio between direct regulatory expenditures and total state revenues, the proportion has nearly doubled since 1986, meaning that states are increasing their expenditures relative to the revenues they derive from the industry, as shown in the following table.[138]

PERCENTAGE OF STATE INSURANCE REVENUES DEDICATED TO REGULATION[139]

YEAR	1986	1988	1993	1996	1998	1999
PERCENTAGE	4.5%	5.4%	6.4%	7.2%	7.7%	8.8%

Changes in state regulatory expenditures (due to cyclical or policy reasons) have an indeterminate effect on industry expenses and profits, since expenditures can change with or without accompanying changes to total assessments on the industry (i.e., the *direct* burden on the industry). In other words, states can spend either a greater portion of the assessments on insurance regulation, thereby leaving less to the general treasury (as they recently have been doing), or they can spend a lesser portion, thereby leaving more to the general treasury. Thus, changes in state expenditures only impact industry premiums and profits directly if they are accompanied by parallel changes in the states' assessments on the industry. Given that certain states have been lowering their premium taxes (the chief component of total assessments), it seems likely that total assessments on the industry relative to premiums will continue to decline. Similarly, unless states reduce their direct spending on regulation, the ratio between their expenditures and total insurance revenues will remain at the higher levels observed in recent years.

Increased spending by states has important implications on the efficiency of regulation and its cost to the industry.[140] The critical question is where the additional spending is occurring and what effect it is having on the market. In the broadest terms, increased state expenditures can shift the burden of regulation from the industry to the states, provided that the *scope* and *intensity* of regulation do not likewise expand. In other words, if the scope and intensity of regulation were held constant while regulatory expenditures were increased, then it is reasonable to expect that the states will be able to regulate more efficiently, or at least with less *indirect* burden on the industry.[141] If, however, increased expenditures

138 On an absolute basis over the same period, state regulatory expenditures have nearly tripled from $310 million in 1986 to a budgeted $910 million in 2001. See NAIC, *Insurance Department Resources Reports*.

139 See Grace and Klein (1999) at 25; Consumer Federation of America ("CFA") (2000); Gettlin, Robert H. "State Spending: The Price of Regulation Plateaus." *Best's Review P/C*, March 1998 at 73-74.

140 Despite the steady increases in state spending, both absolutely and proportionally, the Consumer Federation of America has called for significant further increases in spending and asserts that funding of the state regulatory system remains 25 percent below its targeted minimum level. See CFA (2000).

141 Here, indirect burden refers to the effect on the industry's direct compliance costs as well as the indirect effects on market efficiency. The *direct* burden refers to the states' total assessments on the industry, which are assumed not to change.

were used to support expanded and/or more rigorous oversight, then efficiency gains and reductions in the *indirect* burden on the industry would be less certain.[142]

The recent increase in state expenditures has been directed primarily toward expanding staffing and salaries, as well as improving automation.[143] With more and better-paid regulators having increased computer and other automation capabilities, regulation should be more efficient and potentially more effective. Nevertheless, while the efficiency of the states' regulation likely has improved in certain respects, there is evidence that the increase in expenditures has led to expanded financial oversight and consumer protection activities.[144] Thus, it is unclear whether the increased state expenditures have tended to relieve or increase the industry's compliance burdens. In all likelihood, administrative efficiency gains have been offset by expanded and intensified oversight.

Following the recent rise in state regulatory expenditures, both in absolute and relative terms, expenditures in the near-term are expected to remain near current levels.[145] On one hand, state regulators continue to report staffing difficulties, in terms of expertise and retention, that will continue to pressure personnel costs, as well as the need to continue historically high investments in computer and other automation capabilities; on the other hand, ongoing deregulation and simplification efforts will tend to reduce overall costs and keep them closer to current levels. Deregulation and reform efforts, as well as other changes associated with GLBA, could push spending by the states and NAIC higher in the short-term as new initiatives are pursued, although these efforts should achieve cost savings in future years. The possibility exists, however, that the complexities of regulating an increasing number of companies that are diversified across two or more segments of the financial services industry and/or more active internationally could limit these gains.

The critical points when assessing state spending are:

- The net effect of increased state regulatory expenditures on industry compliance costs hinges on whether the expenditures are directed toward improving existing procedures and practices, or expanding and intensifying them — i.e., the trade-off between *better* and *more*. As the states spend more, they can either facilitate and/or replace efforts and compliance costs by the industry (thereby reducing the *indirect* regulatory burden on the industry), or they can increase demands made upon the industry through more rigorous and expanded oversight (thereby increasing the *indirect* regulatory burden on the industry). The same point is true in reverse for *decreased* state spending (i.e., the trade-off between *worse* and *less*).

- Increases or decreases in state spending by themselves, therefore, are not necessarily positive or negative for the industry and market. There are valid arguments on either side that increasing or decreasing state spending is the best way to decrease the indirect regulatory burdens on the industry. Ultimately, the conclusion is dependent not upon how much the states spend, but upon the manner in which they make those expenditures.

142 See Grace and Klein (1999) at 25-26. Direct regulatory expenditures by the states constitute a relatively small proportion (estimated at 20 percent) of the direct compliance costs of the industry (discussed below). Consequently, even large changes in direct regulatory expenditures may only have a relatively minor effect on the industry's direct compliance costs, notwithstanding a possible multiplier effect. Nevertheless, there is a clear link between state regulatory expenditures and total compliance costs of the industry, even though the direction and magnitude of that link is not clear.

143 IBID.

144 IBID. At the same time computers and other automation efforts have greatly reduced costs associated with the generation, submission and dissemination of both raw data and analyses, they also have brought about a sweeping increase in the amount of data required and depth of analysis undertaken, particularly with respect to financial regulation.

145 See Grace and Klein (1999) at 26; Gettlin, Robert H. "State Spending: The Price of Regulation Plateaus." *Best's Review P/C*, March 1998 at 73-74.

- While direct regulatory expenditures may be an important driver of industry compliance costs and indirect market effects (discussed below), they are relatively insignificant by themselves, as well as in relation to state revenues collected from the industry, industry premiums, and industry profits.

- Due to their tangibility and certainty, state regulatory expenditures tend to receive disproportionate attention in evaluations of regulatory efficiency and effectiveness. Given the far greater significance of the other costs of regulation, the attention given to state regulatory expenditures is not commensurate with its impact on the industry (excluding the downstream effects of those expenditures). Thus, attention should be shifted away from these expenditures toward the other regulatory costs discussed later in this section.

3. ANALYSIS OF STATE EXPENDITURES

Significant variations exist among the states in both revenues collected and expenditure amounts. Annual per capita premium taxes range from as little as $8 (Illinois) to as much as $74 (Hawaii), with an average of $34.[146] Most of this variation is explained by the degree to which each state relies on premium taxes to fund its general treasury, as opposed to paying for its conduct of insurance regulation. Consequently, the revenues collected by each state from the insurance industry do not necessarily correlate closely with its particular expenditures.[147]

State regulatory expenditures correlate more closely with the volume of business regulated (premiums written), though the relationship tends to vary by state according to several predictable factors — the number of domiciliary companies, the relative intensity of regulation, and the extent to which the states offer special services such as in-house liquidators.[148]

The data required to evaluate the specific regulatory areas to which the states direct their expenditures are not available, although NAIC does track the states' total *employment* by regulatory function. *Assuming employment is a reasonable proxy for expenditures*, these data suggest that financial regulation alone accounts for nearly half of total expenditures, while consumer services account for nearly one-quarter of the total. The remainder is allocated to company and producer licensing (7-8 percent), rate and form regulation (11 percent) and market conduct (7-8 percent).[149]

Based on these proxy data, financial regulation represents the largest category of state expenditures. This category is the most widely accepted as necessary to correct or offset market failures. Given its relatively large share of the total expenditures, changes in the scope or intensity of financial regulation have the potential to have the greatest impact on overall expenditures.

Consumer protection and market conduct (excluding rate and form regulation) together account for roughly one-third of overall state expenditures. Like financial regulation, this area of oversight generally is considered to be responsive to bona fide market failures, although there is considerably more controversy regarding the effectiveness and efficiency of its conduct. Most of the controversy concerns the extensiveness of regulatory intervention (including redundancies) and whether it exceeds that necessary to address the pertinent market failures. Thus, given the relative size of these expenditures and the costly implications of excessive regulation, reduced intervention in this category could lower overall spending significantly while providing substantial indirect benefits to the market.

146 *The Insurance Industry — A Key Player in the U.S. Economy, 7th Ed.*, Alliance of American Insurers, 2000, using 1998 data from the U.S. Bureau of the Census.

147 According to the CFA, the variation among the states is substantial, but does not fit an identifiable pattern in terms of region, market size or even political leaning. Certain jurisdictions (Washington, DC, Florida, Louisiana, Massachusetts, New York, Oregon and Wyoming) devote 12 percent or more of their premium tax revenues to insurance regulation, while other states (Arizona, Georgia, Indiana, Nevada, South Dakota, Tennessee and Utah) devote less than 4 percent. See CFA (2000).

148 See Grace and Klein (1999) at 24.

149 IBID at 26 (based on NAIC's 1997 Insurance Department Resources Report). Employment in the financial regulation area includes financial examiners and analysts, as well as liquidators.

The case for the other areas of regulation — licensing and rate and form regulation — stands in marked contrast. These areas account for relatively small shares of overall regulatory expenditures (18-19 percent combined),[150] but a seemingly disproportionate share of the complaints and criticisms from the industry. As noted previously, the relatively high level of controversy arises most directly from the absence of a clear rationale for such regulation — i.e., based on clear market failures of demonstrable impact — rather than from its inefficient or ineffective conduct, although the latter tends to receive much of the attention.

Efficiency concerns, however, are critically important to the industry, since they affect its direct compliance costs. Under such circumstances, the efficient conduct of unnecessary or excessive regulation becomes the next best alternative to more effective regulation generally, in order to minimize both its direct and indirect costs. The critical point is that the focus on achieving the next best alternative — making unnecessary regulation less costly and more efficient — may come at the expense of the best alternative — eliminating such regulation altogether. To a certain extent, efforts focused on improving the conduct of, or otherwise curbing, ineffective and unnecessary regulation, while perhaps more achievable than seeking its complete elimination, inadvertently tend to validate the necessity of such regulation in the first place. Nevertheless, this focus is understandable given how firmly entrenched and resistant to change many of these regulatory processes have become.

Due to their relatively small share of total expenditures, incremental reductions in licensing and rate and form regulation can produce only limited savings in direct expenditures overall. Even the elimination of regulation in these areas would reduce state expenditures by only 18-19 percent overall, or by approximately $160-170 million. Nevertheless, the downstream effects on industry compliance costs and indirect costs would be far more substantial, such that any reductions in these areas are worth pursuing, even if the savings are redirected to increase direct expenditures in other, more critical areas of regulation (i.e., financial regulation and consumer protection).

B. DIRECT INDUSTRY COMPLIANCE COSTS

1. EMPIRICAL EVIDENCE[151]

As noted above, the direct burden of state assessments on the industry was $10.2 billion in 1999, or 1.1 percent of total industry premiums.[152] The latter ratio has been declining steadily from 1.7 percent in 1988, to 1.3 percent in 1997, and to 1.1 percent in 1999.

This decline is very significant for the industry. If this ratio had stayed steady at the rate prevailing in 1988 (1.7 percent), total assessments paid by the industry would have been $15.3 billion, or approximately $5 billion *higher* than they actually were in 1999.[153] Clearly, the states' direct assessments of taxes and fees are the most obvious of the burdens of state regulation on the industry.

In addition to state assessments, the industry incurs substantial costs for its internal and external compliance efforts, which are reflected in its administrative and staff expenses. There is plenty of anecdotal evidence and little doubt that the state-based regulatory system imposes significant compliance costs upon

150 As noted previously, state regulatory expenditures on rate regulation of property and casualty lines alone is estimated at $40-55 million per year. Similarly, state regulatory expenditures on producer licensing and enforcement are estimated at $30-60 million per year, or 5 to 10 percent of each state's insurance department budget. See NAIC (1998) at 5, 17.

151 See NAIC, *1999 Insurance Department Resources Report*, and Grace and Klein (1999) at 23-26, unless otherwise noted.

152 The bulk of the total is derived from state premium and retaliatory taxes. See also, Alliance of American Insurers, *The Insurance Industry — A Key Player in the U.S. Economy* at 12, which reports state insurance taxes by themselves totaled $9.2 billion in 1998.

153 Based on a figure of $900 billion for total industry premiums in 1999, the rate of assessment of 1.7 percent in 1988 would have resulted in total taxes and fees of $15.3 billion, compared to the industry's *actual* taxes and fees of $10.2 billion paid in 1999. The difference is $5.1 billion.

the industry that could be reduced without compromising the integrity of oversight. Most evaluations of the administrative efficiency of the state system focus on the redundancy and lack of uniformity among the states' requirements. These requirements typically include:

- Submitting licensing applications and making appointments;
- Submitting financial and statistical reports;
- Undergoing independent audits and regulatory examinations;
- Preparing rate and form filings, including advertisement approvals;
- Ensuring internal compliance with state regulations;
- Responding to regulatory inquiries; and,
- Paying taxes, fees and assessments.[154]

These general requirements are greatly condensed and each encompasses a range of specific actions. Moreover, these requirements must be performed continuously (whether on an ongoing or periodic basis) and, in many cases, for each state in which a firm operates or conducts business.

Despite widespread agreement on the significance and inefficient nature of these direct costs, only limited empirical evidence is available, including the extent to which they are inflated by inefficiencies and redundancies. It is known that overall insurer expenses unrelated to losses and loss adjustments or commissions are relatively low compared to total premiums.[155] Industry-wide expenses not attributable to loss payments and related expenses or commissions, are likely on the order of 14 to 21 percent of total premiums. The majority of these expenses, in turn, is directed to routine selling/marketing, general corporate and administrative ("SG&A") activities, rather than to compliance activities.

One academic study estimated the industry's total direct compliance costs at $4.5 billion.[156] Given the indirect and approximate nature of the derivation of this figure, however, it is not clear how comprehensive this estimate was intended to be and whether it includes the cost of all the direct compliance activities itemized above or otherwise undertaken by the industry. Nevertheless, taking the figure at face value, it comprises only 0.5 percent of total industry premiums, but nearly 10 percent of net income.[157] The study presents additional data based on regressions of NAIC annual statement data to compute average insurer expense ratios, which are presented in the table on the following page.[158]

Based on these data, SG&A expenses (less commissions) account for 16-19 percent of each premium dollar, or roughly $110 billion per year. In comparison, the industry's estimated direct compliance costs of $4.5 billion account for 4.1 percent of these expenses.[159] While these data indicate that industry compliance costs are substantial in absolute terms, but less so in relation to SG&A expenses, the critical question is what portion of these costs is attributable to compliance with inefficient, redundant or unnecessary regulation? Moreover, how might these costs be impacted if structural changes were made

154 See Grace and Klein (1999) at 30.

155 In an analysis of automobile and homeowners insurance premiums for the ten-year period 1988-1997, losses and loss-adjustment expenses accounted for nearly 81 percent of premiums, while commissions paid accounted for nearly 10 percent of premiums. In contrast, all other expenses, which include direct compliance expenses, accounted for 14 percent of premiums. See Harrington (2000-2) at 36-42. As shown below, NAIC data indicate that these expenses are in the range of 16-19 percent of total premiums written, on average, for all insurers.

156 See Grace and Klein (2000) at 124. The figure was estimated grossly using the assumption of an average cost of $100,000 to be licensed in a given state, with 3,000 companies writing business in multiple states and an average of 15 licenses per company. The authors qualified the reliability of this figure given its gross methodology.

157 Net income based on NAIC nationwide "Quick Stats" for Property/Casualty and Life and Health insurers in 1999 and 2000.

158 Data from Grace and Klein (2000) at 117-125, unless otherwise noted. Percentages are expressed in relation to net premiums written.

159 Derived by dividing the industry's estimated direct compliance costs ($4.5 billion) by the total expenses (less commissions) shown in the table ($61.5 billion for property/casualty plus $49.4 billion for life/health).

AVERAGE U.S. INSURER EXPENSE RATIOS

EXPENSE TYPE	PROPERTY/CASUALTY	LIFE/HEALTH
TOTAL EXPENSES	40.2%	26.3%
CLAIMS ADJUSTMENT	10.9%	NA
NET LESS CLAIMS ADJ.	29.3%	26.3%
NET LESS COMMISSIONS [160]	19.3%	16.3%
SALARY	8.5%	9.1%
LICENSES AND FEES	0.4%	0.6%
ALL OTHER	10.4%	6.6%
NET PREMIUMS WRITTEN *(IN $BILLIONS)*[161]	**$318.7**	**$303.3**
NET EXPENSES LESS COMMISSIONS *(IN $BILLIONS)*	$61.5	$49.4

to the regulatory system to enhance uniformity and reciprocity, and eliminate unnecessary redundancies and other requirements?[162]

In relation to industry premiums, however, estimated compliance costs are not substantial, implying that even significant reductions would have little or no impact on premium prices or overall insurance affordability. Thus, it may be difficult to persuade *regulators* that reducing the industry's compliance expenditures will generate significant benefits for consumers *directly*, at least in terms of the potential cost savings that could be passed on to consumers.[163]

Nevertheless, reducing the industry's direct compliance costs is important to the industry, since they have a more significant impact (representing nearly 10 percent) on industry profits (roughly $50 billion in both 1999 and 2000 [164]). Once again, the critical question is by how much these expenditures can be reduced by eliminating redundant and unnecessary requirements. Using the $4.5 billion figure cited above, a substantial 25 percent reduction in compliance costs would save the industry $1.1 billion before taxes, or an estimated $600-700 million after taxes, equal to about 1.5 percent of industry profits in the 1999-2000 period.

160 Commissions assumed to equal 10 percent of net premiums written.

161 NAIC "Quick Stats, 2000." Includes annuity consideration for Life/Health.

162 In the academic and trade literature, most references to the incremental direct compliance costs due to inefficient or redundant state regulation are vague at best. Some analyses cite the estimated market value or average cost of obtaining licenses in each state (generally $50,000-100,000 per license per state). Other analyses point to the industry's SG&A expenses as the upper bound for direct compliance costs, although this is not revealing since the majority of SG&A expenses likely is attributable to costs unrelated to direct compliance activities.

NAIC has provided rough estimates of certain specific compliance costs. NAIC estimates that the industry's direct compliance costs for rate regulation exceeds $1 billion per year, while licensing-related compliance costs for *producers* alone (including appointments, terminations, applications and renewals, but excluding state fees) are approximately $350 million per year. See NAIC (1998) at 5 and 17. It is difficult to reconcile these estimates with the data presented in the table above. Nevertheless, if these figures (totaling more than $1.35 billion) are subtracted from the estimate of total industry compliance costs above ($4.5 billion), then the costs of all other compliance activities combined (i.e., financial reporting, company licensing, audits and exams, et. al.) are roughly $3.15 billion per year.

163 By the same token, it is difficult to make a compelling case based on this evidence that the industry's direct compliance costs substantially harm consumers, assuming they are passed on in the form of higher premiums. Note that this does not include the substantial indirect costs of regulation, which are believed to be generally harmful to consumers, as discussed in the next section.

164 NAIC "Quick Stats, 2000." Figure represents after-tax net income.

2. ANALYSIS OF INDUSTRY COSTS

In assessing where savings in direct compliance costs might be achieved, it is useful to divide compliance activities between *financial* regulation and *market* regulation, as was done previously for state regulatory expenditures. Financial regulation, which is directed primarily at solvency, is characterized by a far greater degree of uniformity across the states than market regulation, which is directed primarily at consumer protections.[165]

As noted above, financial regulation has benefited from a number of external and internal developments that has improved its functioning, although questions remain regarding its overall effectiveness and capabilities. Certainly, the widespread adoption and application of computer technology have facilitated the entire process of information storage, compilation, analysis, and reporting. Companies and regulators are able to gather, monitor and access much more information at faster speeds and lower costs than was previously possible.

Perhaps even more importantly, NAIC's accreditation and codification efforts have led to encouraging improvements in financial regulation. Although significant variations and redundancies in state-by-state standards and processes persist, financial regulation is far more uniform than it once was and generally far more uniform than market-related regulation. In addition, the achievement of better uniformity has enabled a greater degree of reciprocity, as non-domiciliary state financial exams have been nearly eliminated.[166]

Thus, for financial regulation, more sensible ground rules combined with technology have laid the foundation for more efficient processes. While further structural improvements are needed, particularly with respect to coordination and communication among the states, the bulk of industry complaints in this area pertains to scope issues (what is regulated) and conduct issues (how it is regulated), rather than to structural issues.

In contrast, market regulation is characterized by substantial variations across the states that are often difficult to justify fully. Here, regulation has tended to fall prey to overriding concerns for state preferences and sovereignty, at the expense of efficiency and necessity. Consequently, market regulation is often needlessly redundant and inefficient, and also self-sustaining in that regard.[167] Substantial differences in licensing requirements and rate and form filings generate the need, or at least the justification, for the states to conduct multiple and largely duplicative market conduct exams on both domestic and foreign companies. Moreover, these underlying differences in requirements frustrate efforts to evolve toward unified or coordinated market conduct exams since essentially customized state-by-state assessments still will be necessary to ensure compliance. Finally, increasing criticism regarding the inefficiencies of market-

165 The costs of insolvencies to the industry, in terms of ex-post guaranty fund assessments, are not included in the costs of financial regulation. For purposes of this study, such costs are considered to have occurred *after* the failure of regulation or market forces to prevent insolvency. Consequently, insolvency costs are treated as an indirect cost of regulation since they do not tend to be predictable or otherwise knowable in advance. Therefore, they are discussed in further detail in the next section on indirect costs.

Licensing requirements are often considered financial- rather than market-related regulations. Although unlicensed or otherwise unqualified individuals can contribute to solvency problems, licensing regulations are more focused on professional standards and consumer protections (i.e., market conduct) than financial strength and solvency. For purposes of this study, therefore, licensing requirements are treated as market-related regulations, as are rate and form filings.

166 Grace and Klein (1999) at 31.

167 Indeed, the primary structural weakness of a state-based regulatory system within an increasingly multi-state or broader market is its inherent tendency toward inconsistency and non-uniformity. This is evident in both positive (promulgation) and negative (deregulation) regulatory contexts. When new regulations are mandated, such as the privacy provisions of GLBA, the state-by-state approach has tended to produce multiple, conflicting, inconsistent and, ultimately, inefficient standards. See Morris, Barbara A. "CPCU Teleconference Debate over Gramm-Leach-Bliley Act Focuses on National Agent Registry and Privacy Concerns." *The Rough Notes Magazine*, July 2000.

Even federal guidelines have proven insufficient to promote uniformity if they grant the states significant discretion to enact their own specific requirements beyond the minimum standards. State legislatures have, in fact, exercised such discretion by enacting new privacy regulations under GLBA with unique and state-specific requirements. While NAIC's model law process helps promote uniformity generally whenever regulatory changes are being pursued, in many instances states have been unwilling to quickly adopt model laws as proposed, and frequently diverge by enacting additional requirements. The same tendency is evident in the deregulatory context. The intended benefits of decreased regulation are significantly undermined when the resulting deregulated standards are inconsistent across the states, as is evident in the varying eligibility criteria for exempt commercial policyholders.

regulation may even serve to spur the states to maintain or increase their unique requirements in order to preserve the underlying rationale for their independent action.

On a proportional basis, the industry's compliance costs for financial regulation likely are not as large as state regulatory expenditures on financial regulation. In part, this is due to the industry's comparatively high compliance costs for market regulation, which are believed to be much higher than for the states on a proportional basis. Market regulation is plagued by problems that extend across its scope, conduct and structure, such that substantial improvements in efficiency and effectiveness are possible. In light of the extent of the scope problems (see next section), however, it is uncertain whether the states can make meaningful headway with these problems given the structural weaknesses that lie beneath them. The evidence is not particularly encouraging, as manifest in the disparate pace and nature of the reforms to date.

Arguably, problems of scope can exacerbate problems of structure. In effect, regulatory overreach provides greater opportunity for regulatory structure to exert an adverse impact. Stated differently, as market conduct regulation expands, the opportunities for non-uniformity and redundancy increase commensurately in terms of both compliance and enforcement, such that scope problems may be magnifying the structural problems. If this is the case, then efforts by the states to address the scope problems could produce corollary improvements in at least the perception, if not the substance, of the structural problems.

As a starting point, better balance among regulatory priorities likely would be achieved if the industry's compliance costs were more symmetrical to the states' expenditures.[168] This means giving greater emphasis to core solvency and consumer protection compliance activities and less emphasis to other market-related compliance activities such as licensing, and rate and form approval. Even if the industry's total compliance costs remained unchanged, significant gains in efficiency and effectiveness likely would result from merely shifting the industry's costs among these areas. Nevertheless, the ideal approach involves a combination of reducing the industry's compliance costs overall, as well as reorienting the balance according to regulatory priorities that are focused on true market failures.

The critical points when assessing the industry's direct compliance costs are summarized below:

- The industry's direct compliance costs likely are several orders of magnitude higher than the states' direct regulatory expenditures;

- The industry's direct compliance costs likely have decreased significantly in relation to total premiums, paralleling the sharp decrease in state assessments paid by the industry vis-à-vis its total premiums;

- The industry's direct compliance costs likely are substantial in absolute terms and in relation to total industry profits, but not substantial in relation to total industry premiums and overall SG&A expenses;

- Even if a 25 percent reduction in industry compliance costs could be achieved, the effect on after-tax profits (if retained) would be small, while the effect on premium prices (if passed on to consumers) would be insignificant.

- In comparison to state regulatory expenditures, the industry's compliance costs appear to be much more heavily weighted toward market regulation (particularly licensing and rate and form approval). This may be due in significant part to the comparatively less uniform and redundant nature of compliance with market-related regulations vis-à-vis financial regulations.

168 For instance, based on the data provided above, 11 percent of the states' expenditures are directed toward rate *and* form regulation, while more than 20 percent of the industry's costs are tied to rate regulation alone.

C. INDIRECT COSTS OF REGULATION

1. INTRODUCTION

Since *direct* expenditures by regulators and direct compliance costs of the industry are tangible and easier to grasp, they tend to receive the most attention in evaluations of regulatory scope and structure. The *indirect* costs of regulation to the industry and consumers, however, are undoubtedly far greater, by many orders of magnitude, than these direct costs, even though their exact size is much more theoretical and difficult to pinpoint.[169] Many insurance regulations, based on both the conclusions of numerous empirical studies as well as anecdotal evidence, exhibit a clear tendency to cause unnecessary and/or unintended, but potentially very costly, distortions in key areas of market functioning and efficiency. Primary examples include the tendency of solvency regulation to promote *moral hazard* problems on the part of both consumers and insurers, and the tendency of price regulation to increase price variability, reduce availability and ultimately undermine solvency. While the exact mechanisms that produce these distortions are varied and complex, they often share two fundamental and interrelated characteristics:

- They undermine competitive market forces that generate incentives for loss control; and,
- They interfere with the normal relationship between premium levels and expected loss costs.

As a threshold matter, the overall cost of risk to the economy over the long-run, as opposed to consumer costs in the short-run, is the most relevant criterion for assessing market efficiency. From a different perspective, the cost of risk to the economy is reflected in the overall level of social welfare or combined consumer and producer surplus taken as a whole.[170] Generally, regulation can either:

- increase the cost of risk and decrease overall welfare by imposing costs without corresponding benefits or by distorting the market's allocating function; or,
- reduce the cost of risk and increase overall welfare by correcting or offsetting market failures and improving market efficiency.

In practice, regulation produces both of these outcomes in part. Setting aside social goals that may or may not have economic merit, regulations that interfere with incentives for loss control or with the relationship between expected loss costs and premium levels go far beyond the basic rationale for regulation — to correct or minimize market failures. In fact, such regulations tend to exacerbate if not promote market failures, and increase the overall cost of risk. They are extraordinarily costly and fall far short of providing a commensurate level of benefits to the market, and especially to consumers, even when consumers appear to accrue some benefit.

While these regulations may exist to serve some other well-intentioned and perhaps economically justified regulatory purpose (which may or may not be achieved), their indirect or unintended effects often can be far greater and seriously detrimental, on balance. While it is certain that the indirect and unintended effects are far more substantial than the direct costs of regulation, they also are much more vague or obscured behind the more proximate rationales for the regulations (e.g., improving affordability). Although the costs of these effects are difficult, if not impossible, to measure with precision, the effects

169 The same is true for the indirect *benefits* of regulations, which manifest themselves in terms of improved solvency, market conduct, affordability, returns on investments, system stability and consumer confidence.

170 See Grace and Klein (1999) at 32-33. For example, increasing affordability at the expense of insurer profits or surplus provides no net gains to the *overall* economy, but rather merely shifts the burdens of the cost of risk among market participants (i.e., from consumers to insurers). Moreover, such a shift can potentially increase the overall cost of risk (thereby reducing economic welfare) by reducing the availability of coverage (which increases the potential for uninsured losses), reducing insurer claims-paying ability (which increases potential insolvency costs), and reducing loss control incentives for insureds (which increases loss costs).

themselves are numerous and usually observable. This section of the report provides a summary and abbreviated discussion of some of these effects and interrelationships.

2. SUMMARY OF DISTORTING EFFECTS

A. RATE REGULATION AND SUPPLY AVAILABILITY

The explicit goals of rate regulation are to promote affordability and coverage for consumers, and prevent destructive competition among insurers. These goals are complexly interrelated, which often can cause them to conflict with each other. Like the story of Goldilocks, rate regulation seeks to maintain prices that are "just right" — neither so high as to restrict affordability, nor so low as to reduce availability (and potentially threaten insurer solvency if accompanied by regulated exit barriers). There is considerable evidence, however, that rate regulation accomplishes neither goal, especially in the long-run. Within the confines of a fast-moving market that is structurally competitive, this outcome is not surprising. By attempting to control or limit prices, such regulation interferes with normal market-clearing dynamics, thereby triggering a chain of generally adverse or undesirable reactions in the behavior of both insurers and consumers.[171]

While constraining prices through price ceilings and discretionary approval may improve nominal affordability in the short-run, consumers do not benefit if, in response, insurers limit supply or withdraw from such markets entirely. Other effects include: deterioration in product quality and service (as insurers try to compensate for price suppression); reduced entry or incentives to innovate, invest and expand; reduced profits, as well as increased operating and insolvency risk for insurers; and perhaps most importantly, reduced incentives for loss control.[172] Thus, even though rate regulation is intended to promote more parties to insure and greater insurance coverage overall, the downstream or indirect effects tend to undermine if not frustrate that goal entirely. Regardless of the outcome, the result is neither efficient nor consistent with market principles within a structurally competitive industry.[173]

Similarly, given the lack of evidence that insurance markets are prone to destructive competition, *price floors* and other supports tend to reduce competition (or inefficiently shift it to non-price factors), advantage less efficient insurers over more efficient insurers, and, ultimately, harm consumers. Other effects include: discouraging entry of low-cost providers (who are limited in capitalizing upon their cost advantages); promoting excessive loss control by insureds; and, discouraging other parties (those with low-risk or affordability issues) from insuring.[174] Thus, while rate regulation is intended to limit destructive price competition and ensure supply, in practice it tends to limit competition overall and reduces the amount of insurance coverage either offered or purchased. Ultimately, the better approach likely centers on regulatory restraint to the extent possible, and redirecting regulation to help minimize barriers to entry and exit and ensure adequate profit levels, which together will promote adequate supply at competitive prices.

B. RATE REGULATION AND RATE LEVELS

As it should be, the primary influencing factor on rates is insurer loss ratios, which do not appear to be

171 Historically, rate regulation schemes developed following the move away from bureau pricing, as regulators sought to ensure the fairness of rates, particularly in compulsory lines (to promote affordability in mandated coverages) and personal lines (where information constraints and principal-agent conflicts are perceived to uniquely disadvantage individual consumers).

172 See Harrington (2000-2) at 31-43.

173 The states and NAIC have attempted to set bounds on regulatory discretion to control rates by requiring more rigorous and objective determinations of market failures as a precondition for such intervention. These "competitive rating" systems are a distinct improvement over generally more restrictive "prior approval" systems and have led to greater reliance on market forces in rate-setting and, therefore, represent a step in the right direction. Nevertheless, the competitive rating approach adds another layer of regulatory discretion with regard to making determinations of the competitiveness of a given market. Moreover, the stringency with which competitive rating laws are applied in practice can vary across the states.

174 IBID.

affected by rate regulation.[175] Among individual states, however, there is a clear relationship between the stringency of rate regulation and average rate levels. States with the highest insurance costs are most likely to regulate rates in the first place, while those with prior approval and conditional prior approval systems have higher than average expenditures for insurance.[176]

Although strict rate regulation would be expected to contribute to rate stability, the opposite is generally true in practice. The variation in rates over time is much greater for states with rate regulation than those without it.[177] There may be a number of legitimate reasons for this outcome, but clearly one factor is the tendency for rate regulation to produce fewer but larger rate changes. Due to the time and expense of new rate filings, insurers are less likely to adjust rates either higher or lower until changes in expected costs become significant enough to justify new filings. Thus, filings are less frequent but usually involve larger changes than they would if prices were allowed to change freely, particularly when insurers are seeking rate increases. Moreover, given the constant threat of regulatory suppression, rates are likely to become rigid as insurers defer timely rate decreases when loss-costs decline.[178]

A few states continue to maintain excess profit laws, which constitute an indirect form of rate regulation with similarly distorting effects.[179] Arguably, such restrictions are less stringent than direct rate regulation since they are not binding until presumably excessive rates yield excess profits. Nevertheless, such laws have the potential to be *more* distorting since they tend to be more binding on efficient firms, which effectively can be penalized if their higher profits stem from favorable expense ratios that have nothing to do with premium levels. Thus, rather than rewarding insurers for operating efficiencies, effective risk classification and selection, or generating above average investment returns, excess profit laws redirect the benefits back to insureds, who may have done little, if anything, to help produce the "excess profit."[180]

In addition, excess profit laws are unidirectional and, therefore, penalize insurers during their relatively low loss-cost years, while providing no relief in relatively high loss-cost years. Moreover, as noted above, the measurement of insurer profits is subject to considerable complexity due to difficulties related to portfolio valuation and attributing profits to particular lines and state jurisdictions.[181]

C. RESIDUAL VERSUS VOLUNTARY MARKETS

Since residual markets serve both economic as well as social goals, they cannot be expected to meet strict efficiency criteria, although they still should be administered as efficiently as possible. Residual markets are a product of regulatory intervention (due to compulsory coverages and the desire to minimize uninsured losses) and have the ability to impact the voluntary market directly.[182] They also reflect the tendency of regulation (i.e., compulsory coverages) to beget more regulation (i.e., residual markets).

Clearly, compulsory coverages and mandated supply are directly at odds with normal market forces,

175 IBID at 37-38.

176 IBID at 38-42. Due to the overriding importance of loss-costs, this does not mean that every state with prior approval or conditional prior approval regulations has higher rates than states without such regulations. In addition, the nominal classification of a state's regulatory process does not necessarily distinguish for different degrees of regulatory stringency. For example, some competitive rating states regulate more stringently than some prior approval states. See Feldhaus and Klein (1998) at 52.

177 See Harrington (2000-2) at 31-43.

178 IBID at 33.

179 IBID at 11.

180 The potential for regulated rate refunds provides strong disincentives for insurers to generate excess profits. Rather than reduce rates as the regulations intend, however, insurers instead may increase non-price product factors by providing additional services (thereby generating higher expenses) or relaxing claims-paying criteria (thereby increasing loss costs and rewarding claimants).

181 IBID at 19-20. In addition, evaluations of portfolio values and unrealized gains and losses may differ significantly from realized gains and losses.

182 See, generally, Harrington (2000-2); see also Feldhaus and Klein (1998) at 59-60, 85-86. State- and federally-sponsored or administered insurance plans represent the extreme form of this type of regulatory intervention, and more clearly exemplify the public welfare goals of residual markets.

although they accomplish certain social and economic benefits that the market might not otherwise achieve. First, compulsory insurance increases incentives for loss control, since it requires individual insureds to bear a greater portion of their risks that might otherwise go uninsured.[183] Second, compulsory insurance reduces the amount of uninsured losses ultimately borne by others.[184] The critical question is whether regulation provides the most efficient way of accomplishing these desirable goals.

In addition to the direct costs (state regulatory expenditures and industry compliance costs), residual market regulations impose significant indirect costs on the market through their tendency to distort conditions in the voluntary market, as follows:

- Residual market rates constrain voluntary market rates;
- Residual markets can limit supply in voluntary markets ("crowding out"); and,
- Residual markets can derive effective cross-subsidies from voluntary markets if they interfere with the normal relationships between premiums and relative risks or expected loss costs.[185]

Given the purpose of the residual market in the first place, it should always be relatively small and limited. A large and/or rapidly growing residual market constitutes de facto evidence of regulatory failure. The evidence is clear and most directly tied to distorting rate regulation in voluntary markets, as states with prior approval regulations have comparatively large residual markets, as insurers reduce supply in response to regulated rate suppression in the voluntary market.[186] Similar distortions can occur when residual market rates are suppressed by regulation at the expense of rates in other markets (i.e., in voluntary markets in the same state, or in both voluntary and residual markets of other states).[187]

D. ALTERNATIVE VERSUS TRADITIONAL MARKETS

The existence of expanding alternative markets and increasing use of non- or lesser- regulated products is symptomatic of failures in the regulated market and its traditional products.[188] These failures reflect product cost inefficiencies and product/coverage inflexibilities. Although other factors certainly have contributed to this shift, when direct and indirect regulatory costs exceed their corresponding benefits, regulated products and markets are disadvantaged vis-à-vis alternative markets and other financial

183 See Harrington (2000-2) at 27-29.

184 IBID.

185 See, generally, Harrington (2000-2). While the subsidization of certain insureds can be an acceptable social goal, especially if it ultimately increases overall economic welfare, the method by which the subsidization occurs is an important consideration since it determines to whom the subsidies are provided and by whom the costs will be borne. The critical issue here is the efficiency with which the subsidies are actually conferred from the bearers to the receivers, and whether this type of regulation, by causing cross-subsidies between markets, accomplishes the desired subsidization at the lowest cost. Alternatively, the subsidization might be accomplished more efficiently if direct payments were made to lower premium costs as desired, rather than by controlling market mechanisms. See Harrington (2000-2) at 29.

186 IBID at 20-22.

187 IBID at 13-14, 32.

188 Liberty Mutual (2001) at ii, 6, 13-14. While this evolution may mark failures in the traditional regulated insurance market, it may produce overall welfare gains in terms of the cost of risk, and reflected in consumers' preference for less governmental regulation (whether in terms of pricing or product features). Nevertheless these "gains" are not strict improvements as much as they are an avoidance of the potential losses imposed by regulations and other perceived limitations in the traditional regulated market. See also Feldhaus and Klein (1998) at 28, 40-41.

189 Certainly the greatest stimulus to alternative markets, particularly captives, has been the expense or lack of availability of certain coverages in the commercial market. Related reasons include the desire to recapture underwriting profits and investment income, to gain access to the reinsurance market, to diversify into insurance services, and to obtain customized coverages based more on specific *risk-driven* rather than *market-driven* factors, enhanced services and reduced frictional costs. See, for example, Ostermiller (A.M. Best); NAPSLO; NAPSLO/KPMG; Marsh.

service products that are not similarly constrained.[189] Inevitably, these imbalances lead able consumers to avoid regulated products and markets in order to minimize their costs and maximize their individual welfare by obtaining more suitable products.

Significantly, all segments of the insurance market — reinsurers, primary underwriters, agents and brokers, and consumers — are participating in this shift, indicating that the adverse and indirect effects of regulation are widespread and well- known. The participants tend to be larger and more sophisticated and, therefore, more capable of assessing the differences between traditional and alternative markets, including understanding the effects of regulation on premiums, coverages and the overall cost of risk for various products. While efforts to deregulate commercial lines seek to narrow incentives to move into alternative markets, they are proving to be "too little, too late" given the significant withdrawal from the traditional market by the largest commercial buyers.[190] Nor is deregulation expected to lure these buyers back to the traditional market, although it is hoped to slow or limit withdrawals by middle-market accounts which have begun to occur.[191] Although hard market pricing and limited capacity in the mid-1980s spurred shifts to the alternative market, the extended soft market of the mid- to late-1990s did little to reverse or even slow this flow, indicating that pricing, while important, has not been the sole motivating factor.[192]

No matter what the motivations, a clear trend away from traditional markets is in place and will likely overcome regulatory efforts to slow or reverse the trend. This is due to much larger forces at work, including financial services convergence (which will introduce new capital and products for risk-financing), reductions in trade barriers, and increased globalization. When these forces are coupled with a relatively favorable regulatory climate, the alternative markets should continue to exhibit improved efficiency and control as well as innovation and flexibility vis-à-vis traditional markets. It is estimated that alternative markets now account for nearly half of the U.S. commercial property and casualty primary business[193] and their growth continues to outpace that of traditional markets.[194]

While certain U.S. states led by Vermont and Hawaii have passed legislation to allow formation of captive insurance companies, much of the current activity and expected future growth is concentrated in overseas and offshore markets, which enjoy distinct advantages over domestic captives in terms of taxes and less complex/stringent regulation. There are numerous reasons to expect that alternative markets, led by captive insurance and risk securitization instruments, will continue to grow at the expense of traditional regulated markets:[195]

- Greater access and opportunities being provided to middle- and small-market accounts;
- Recent hardening in most P/C lines since late 1999;
- Department of Labor ruling in 2000 that liberalized the insuring of employee benefits through captives;
- The increasing degree of financial services convergence, as well as multistate and global operations; and,
- The uneven pace of state regulatory reform and modernization.

The catastrophic losses due to the recent terrorist attacks (and related life, business interruption and workers' compensation claims) have caused very significant increases in premium costs, as well as limited the availability and coverages in affected traditional markets. Consequently, these events will provide

190 See NAIC (1998) at 2, 10 (citing Conning & Company, "Alternative Markets — Evolving to a New Layer," 1996).

191 IBID.

192 See Bowers (1999).

193 Liberty Mutual (2001) at 6. Another factor cited is the lack of reinsurance capacity.

194 See A.M. Best (2001) at 15.

195 IBID.

further impetus toward alternative markets. As noted above, similar conditions prevailed in the 1980s in the liability market leading to the LRRA of 1986, which spurred significant growth in risk retention groups (RRG) and purchasing groups (PG). As of 2001, total RRG premiums had reached $895 million, while total purchasing group premiums had reached an estimated $3.0 billion.[196] Due to pricing and coverage problems in the property market following the terrorist attacks, a number of industry interest groups have called for an expansion of the LRRA to cover property risks.[197]

The states, led by NAIC, are attempting to slow the exodus to alternative markets by deregulating commercial lines or, failing that, promoting the use of domestic captives. Nevertheless, the continuing migration to alternative markets has important implications regarding the existence (or absence) of market failures, the effectiveness of regulation in addressing those failures versus causing distortions and inefficiencies, and the extent of regulatory reach or control over the business of insurance. Simply put, more and more insurance business is migrating away from state regulatory control, which raises several important questions:

- What are the implications on the insurance market as a whole of the increasing and significant proportion of transactions beyond the control of state regulators?
- While alternative markets have provided gains in cost efficiencies and specific coverages, are solvency and market conduct conditions generally as sound?
- What does the increasing use of non-admitted, excess and surplus and alternative markets collectively say about consumers' preferences for regulatory protections vis-à-vis product cost and availability?
- To what extent can structural reforms narrow the disadvantages inherent in the traditional regulated markets vis-à-vis alternative markets?

E. RISK CLASSIFICATION RESTRICTIONS

Risk classification restrictions, in effect, act as indirect rate regulations, since they dictate the permissible variations in rates for buyers of the same coverage.[198] While there may be valid social reasons for such restrictions (such as avoiding unfair discrimination and promoting affordability), the resulting interference between expected costs and premiums adversely impacts market efficiency and produces similar distortions as direct rate regulations. As is the case for rate regulation, competitive markets provide strong incentives for accurate risk classification, which, in turn, provides incentives to higher-risk insureds to control losses, but only if premiums are permitted to reflect expected costs.[199]

While rate and risk classification regulations seek to control the insurer's behavior, ultimately they distort relationships between higher- and lower-risk insureds by generally decreasing costs to the former while increasing costs to the latter. This distortion in relative costs extends to normal incentives for loss control by raising them for low-risk insureds while lowering them for high-risk insureds. Ultimately, this

196 See Risk Retention Reporter, *RRG Statistics and PG Statistics*, downloaded at http://www.rrr.com/education/growth.cfm.

197 Some proponents of expanding the LRRA do not believe the expansion should be limited to property risks, but should include any line of insurance that might benefit from increased competition, greater product flexibility and reduced regulatory constraints. The lines that are not considered appropriate for such coverage generally include personal lines and workers' compensation, although increasing problems in the latter market may generate similar proposals. Two of the main problems faced by RRGs have been continued friction with state regulators (notwithstanding the preemption features of the LRRA) and shortage of fronting capacity following the demise of several important fronting carriers for captive groups. Expanding the LRRA to cover other risks may help attract new fronting capacity by expanding the potential premiums at stake. See Pilla, David. "Risk Retention Groups Lobby Congress for Expanded Role." *BestWire Services*, April 4, 2002.

198 See Harrington (2000-2) at 1.

199 IBID at 18-19, 23-24.

results in adverse selection for insurers as more high-risk buyers insure (or insure more) while more low-risk buyers do not insure (or insure less/self-insure).[200]

While rate classification restrictions can improve nominal affordability for some buyers, their overall benefits likely fall far short of their costs. In addition to the direct costs to the states for monitoring and enforcement and industry compliance costs, the artificial improvement in affordability for selected classes of consumers causes affordability overall to *decrease*. This has been described as a "negative-sum system of cross-subsidies," which also applies to rate regulation, whereby limited benefits to a minority portion of the market come at high costs to the overall market. The impeding of normal loss control incentives inexorably leads to higher claims costs overall.[201]

F. REGULATION OF POLICY FORMS

The regulatory goals of requiring policy form approvals are substantively sound, although it is less clear whether they are efficient. The goals are to compensate for purchasers' information and bargaining power deficiencies vis-à-vis insurers and to facilitate comparison shopping, thereby promoting competition. Insurers likewise benefit from more standardized bases for the development of loss experience and cost information.[202] The relevant questions are: 1) whether these deficiencies constitute a market failure; 2) whether policy form approvals are the best way to accomplish the stated objectives; and, 3) whether the benefits of such regulation are sufficient relative to their costs.

Purchaser information and bargaining power deficiencies are neither uniform nor insurmountable, which has led at least some states to deregulate policy forms for large commercial buyers. The degree of customization permitted in policies for large buyers essentially precludes both insureds and underwriters in this segment from receiving significant benefits from the regulation of policy forms, which instead simply imposes additional costs.[203]

The indirect costs of policy form regulation can be significant, however, while its benefits can be questionable, the primary of which is that coverages may be more consistent with minimum standards established by the states.[204] Those standards, however, may not be relevant to many buyers even as administering those standards imposes costs upon them. In addition, such standards can prevent or significantly delay buyers from obtaining more suitable products,[205] particularly under conditions of rapidly changing markets and insurance needs. Consequently, purchasers of regulated policy forms often over-insure in certain areas and under-insure in other areas.[206] Form approval restrictions also undermine insurers'

200 IBID at 32.

201 IBID at 43.

202 IBID at 44-45. Arguably, consumers and insurers could also benefit from economies of scale in the production of standardized policies. Given the relatively low level of insurer expenses, however, the economies would have to be substantial in order to exert a significant impact on premiums. Moreover, while the benefits of pooled loss data to insurers are unmistakable, there is little empirical evidence concerning the actual efficiency benefits to insurers of the improvements in the accuracy and reliability of expected loss costs derived from these data. It is not clear, therefore, the extent to which these data would suffer with less perfect standardization and/or smaller sample sizes. Even if the accuracy of pooled loss data deteriorated as a result of less stringent regulation and greater product differentiation, the question remains whether such deterioration would be significant enough to impact the market adversely, or whether alternative methodologies and other adjustments could be employed by insurers to increase the reliability and use of the data.

203 The customized nature of their policies indicates that large insureds have both sufficient information and bargaining power vis-à-vis insurers. In addition, such customization essentially precludes the ability of regulation to facilitate standardization and comparison shopping on behalf of insureds, as well as the development of standardized loss experience and cost information on behalf of insurers.

204 In large part, these standards are derived directly from specific state differences and variations in insurance and related laws that define or govern losses and fundamental contractual obligations.

205 Here, regulation has the potential to introduce a significant market failure to the extent that it prevents insureds from obtaining the particular products they want and are willing to purchase. Any other result diminishes security and predictability, and raises the cost of risk to individual insureds.

206 The bulk of the evidence points to the tendency for parties to over-insure and thus bear increased costs for unwanted or unnecessary insurance contained in ancillary coverages and mandatory endorsements enforced by individual states, particularly for multi-state insureds. See NAIC (1998) at 11-13.

incentives to develop and market new products, leaving them unable to fully satisfy their clients (except through alternative means) and at risk of missing important market opportunities. In some cases, such restrictions can cause insurers to withdrawal partially or completely from markets that they believe cannot be served by approved products.[207]

G. LAGS AND DELAYS

Though regulatory lags (e.g., for rate approvals) and delays (e.g., for form approvals) may not impose any tangible costs on regulators or the industry, they impose substantial intangible costs. These costs stem from distortions in the timing between changes in loss costs and premiums, maintenance of excessive and/or inadequate insurance coverage by individual buyers, lost market share or opportunities for insurers, increased risks for both insureds and insurers, and a reduction in overall supply.[208]

Since these costs are difficult to quantify even grossly, they are easily overlooked. A recent study asserts that new product approval delays constitute a "hidden tax." Using econometric modeling, the study estimates that new products effectively face an implicit tax of approximately 9 percent due merely to delays in their approval.[209] These delays cause losses in overall welfare that stem primarily from consumers' inability to obtain the products desired in a timely fashion. Thus, these regulatory frictions are not simply frustrating or inconvenient, but potentially quite costly and distorting. Indeed, the costs may be comparable to typical commissions paid and several times higher than state premium taxes. Unfortunately, such quantifications of such intangible costs are difficult to make and generally unavailable, which obscures them from consumers.

While the costs of regulatory lags and delays to consumers are substantial, they can be even more threatening to insurers. This is true in any environment, but particularly in the current, very competitive conditions. Never before has the industry faced such a combination of threats to existing markets and opportunities in new and emerging markets. The prevailing trends in financial services modernization, electronic commerce, global trade and alternative markets and products share a common denominator — speed and flexibility — two of the primary weaknesses often cited with regard to the current regulatory system.

The causes of regulatory lags and delays frequently are attributed to structural problems of the regulatory system, namely the inefficiencies and redundancies of having to obtain regulatory approval in multiple jurisdictions. Clearly, redundancy is a prime generator of indirect costs and other distortions, such that changes in structure that reduce the number of discrete regulatory jurisdictions could reduce indirect costs significantly.

Nevertheless, the contribution of regulatory scope to these costs must not be overlooked, since scope is where these costs originate before they are magnified by structure. In short, all regulatory decisions require time and generate costs. As those decisions become more extensive (i.e., as regulatory scope increases), the corresponding delays and costs increase proportionally. As those delays and costs are then repeated across numerous jurisdictions, they become more and more intolerable.

Consequently, in the context of evaluating alternative regulatory structures, this interplay must be kept in mind so that scope considerations do not overwhelm structure considerations, and vice-versa. The salient point for the industry is that both scope and structure problems make significant contributions to the overall problem.

207 The supply availability problems in the property market following the terrorist attacks and in the Texas homeowners' market following the onset of toxic mold claims are directly linked to regulated rigidity in policy forms. In both cases, insurers appealed to regulators to approve and allow needed adjustments and endorsements to reflect these risks. The failure or delay of regulators to accommodate these changes, however, contributed to the eventual problems that developed as insurers responded to the lack of product flexibility by withdrawing supply. Thus, this market problem also could be included under the next distorting effect discussed — regulatory lags and delays.

208 See Harrington (2000-2) at 33.

209 See Unnewehr (2001) at 3 (citing Butler, Richard. "Form Regulation in Commercial Insurance." *Working Paper*. Department of Economics, Brigham Young University).

H. RESTRICTIONS ON MARKET EXIT

In response to market and product restrictions (i.e., rate, form and classification restrictions) and other regulatory frictions, the industry has limited options within a given state. In the short-term, the industry simply can tolerate higher levels of direct compliance costs, reduced operating flexibility and lower growth and profits. In the longer term, the industry can undertake more substantive adjustments by reducing costs, reducing service and quality, or making other permitted product-related adjustments (such as adopting higher claims payment standards).[210] If those measures are not sufficient to compensate, then reductions in supply become a more viable alternative, beginning with nonrenewals and cancellations and ending with complete market exit.

Thus, even before any restrictions are placed on the industry's responses to excessive regulation, its range of options is limited. The most extreme option — market exit — constitutes a powerful moderator of excessive or inefficient regulation by exposing its consequences to the market in terms of reduced supply and ultimately higher prices to consumers. While this is an extremely costly option for the industry to employ, less drastic alternatives likewise are fraught with limitations, if not peril. For example, reducing product quality and attendant services or raising claims payment standards can reduce goodwill and impact company reputations, as well as trigger increased litigation.[211] Moreover, nonrenewals and cancellations can attract greater regulatory scrutiny and, by extension, increased compliance costs. In comparison, market exit entails substantially higher costs and disruptions that tend to limit the use of this option, except as a last resort, whether by multi-state insurers seeking to maintain a national presence, or by local or regional insurers who can ill-afford to lose access to any market or line.

Given the limited appeal of market exit or even limited withdrawal, the fact that the industry regularly undertakes these actions or credibly threatens to take them underscores the significance of unnecessary regulatory restrictions and their costs to the industry. The threats are prevalent enough that many states employ second-tier restrictions on the industry's freedom to exit, including constraints on nonrenewals and cancellations, "lock-in" rules and even restrictions on the modeling of loss costs.[212] These further restrictions remove a legitimate check on excessive or inefficient regulation and constitute another example where inefficient or distorting regulation tends to beget more regulation.

In the broadest sense, regulatory exit barriers are directly contradictory to the fundamental rationales for regulation. It is difficult to reconcile the imposition of one clear-cut market failure in the interest of resolving another market failure, whether actual, potential or purported. Furthermore, if exit barriers are imposed in response to market conditions that do not constitute true failures, then they simply cannot be justified.

While imposed exit barriers are undesirable by themselves, they can lead to secondary problems. Initially, the presence of exit barriers also can serve as barriers to entry, as the threat of capital and income expropriation by regulation has a dampening effect on the willingness of new suppliers to enter such markets. Once entered, suppliers who are unable to respond to excessive or inefficient regulation will likely delay exiting due to its high cost, thereby sustaining losses while attempting to salvage investment principal or finding other ways to compensate. In the meantime, they will certainly limit further capital commitments, which increase the possibility of financial distress.[213] Once the costs cannot be sustained, market withdrawal increases costs even further. Finally, the exodus of capacity tends to force

210 See Harrington (2000-2) at 50. Perversely, efficiency gains and other cost improvements achieved by insurers in response to these restrictions can provide the basis for even greater rate suppression, since rates are based, in part, on insurer expense ratios.

211 IBID.

212 IBID at 10, 35-36. Lock-in rules can significantly increase the costs of exit by requiring exiting insurers to abandon all lines of business and subjecting them to residual market assessment surcharges. These costs are in addition to the losses of investment principal that often occur when a market is abandoned.

213 IBID. Exit barriers provide greater incentives to reduce investment than to reduce costs and expenses.

more consumers into residual markets, which, as noted above, is evidence of a malfunctioning market environment.

In the context of evaluating alternative regulatory structures, the imposition of exit barriers is primarily, if not exclusively, attributable to problems of the scope and conduct of regulation rather than of its structure.

I. EXTERNALITIES

The structure of the state regulatory system in an increasingly interstate or even international market makes it prone toward generating externalities.[214] While state-by-state variations in regulatory requirements (i.e., *scope*) are a product of the system's structural weaknesses, they also exacerbate the state system's inherent tendency toward non-uniformity, redundancy, and generating externalities. The generation of negative externalities — when other states accrue a cost without a corresponding benefit as a result of the regulatory actions of another state — is key in this context. While variations in the scope and conduct of regulation often appear to be the root cause of many externalities, in most cases, they are facilitated by the structural limitations of the regulatory scheme.

In some cases, the negative externalities may be intentional, as in the exclusion of large commercial buyers from guaranty fund protections, but not from guaranty fund assessments.[215] Other examples include any situation in which the *incidence* of costs or benefits in insurance transactions specifically is controlled or dictated by regulation. The more regulatory control alters the incidence of the costs and benefits that would otherwise occur, the greater the potential for externalities to occur.

As discussed above, rate and risk classification, as well as residual markets and exit barriers, all have the tendency to produce distorting cross-subsidies among different parties individually, or across different states more generally. In some cases, costs are transferred to insurers, thereby providing benefits to insureds; in other cases, costs are transferred to low-risk insureds, thereby providing benefits to high-risk insureds. It should be clear, however, that the transferring of costs and benefits within the market does not increase overall welfare — i.e., there is no free lunch — unless it corrects a prevailing market failure. Otherwise, consumers simply pay for the benefits shifted to insurers, while insurers pay for benefits shifted to consumers. In the process, however, the distortions that result tend to reduce overall welfare.

Given the state specificity of many areas of regulation prone to externalities, adverse effects stem directly from the differences among the states' regulations and do migrate across state lines. Although these effects are often indirect and unintended, they are easy to overlook even though they are no less harmful or distorting.

Cross-state externalities occur because the avoidable costs of both excessive and lax regulation in one state are easily passed to other states.[216] Excessive regulation increases compliance costs that the industry will seek to recover any way it can, whether in the state where those costs are generated, in other states, or, most likely, in both. Lax regulation can increase the risks of insolvency or fraud/misrepresentation that likewise impact all markets rather than just the market where the lax regulation occurred. The other side of externalities, which is of equal concern, is lack of jurisdiction or regulatory reach. States are limited

214 To reiterate, externalities are costs or benefits that arise from an economic transaction which are borne by parties not involved in the transaction and results from the failure of the transaction price to account for the externality. See Spulber (1989) at 46. Previously, it was noted that externalities involve the unfair or inadvertent shifting of costs and benefits such that a single event gives rise to both positive externalities (to the recipient of the benefit) and negative externalities (to the bearer of the cost). The immediate discussion is focused on negative externalities and omits consideration of the corresponding positive externalities that also are generated.

215 To some extent, these externalities are being offset by the relaxing of regulatory oversight of large commercial buyers. Nevertheless, the imbalance created by the differential treatment of these insureds with respect to guaranty fund protection and assessments inevitably creates distortions that generate indirect costs to the market beyond the obvious costs to this class of policyholders. Such intentional externalities are typically the product of non-market objectives, as evidenced by their tendency to act like direct subsidies, which are generally distorting in nature. One of the primary problems that arises with externalities (unlike direct subsidies), however, is that their costs and benefits usually are not clear to either the bearer or the recipient, respectively.

216 See Harrington (2000-2) at 41-42.

in their ability to control the activities of other states and thus, the extent to which poor operating performance or distortions can be isolated in the state where they arise.

As the foregoing illustrates, structural weaknesses and limitations in the state system tend to facilitate the generation of externalities in the first place, and then magnify them once they arise. Consequently, structural changes to the regulatory system have the potential to reduce the distorting and ultimately costly effects of externalities on the market. The same mechanism that gives rise to externalities in the market, however, can also help control systemic risk, either by providing (through migration) a relief valve or by the internal disciplining forces that develop among states through regulatory competition.

J. SOLVENCY AND MORAL HAZARD

Moral hazard is an issue that arises frequently in the context of all financial services and is not specific to insurance. A good definition of the term is:

> A moral hazard exists when a decision maker takes risks that he otherwise would not have taken, because the adverse consequences of the risk-taking have been transferred to a third party in a manner that is advantageous to the risk-taker and, more important, is disadvantageous and potentially even destructive to the party to whom the risk has been shifted. Insurance is such a risk-transferring device; therefore, the potential for moral hazard exists in any form of insurance, not just in deposit insurance.[217]

Thus, the very concept of insurance is said to give rise to moral hazard by changing the behavior (i.e., reducing the incentives to minimize losses) of those who purchase it. Within the insurance industry, the topic arises frequently in the context of guaranty funds and the potentially adverse effect they can have on the behavior of both insurers and consumers. They permit both insurers and consumers to take risks that they otherwise might avoid in the absence of such protections.

Insurers may employ risky operating strategies in the interest of increasing market share, achieving above-market profits or simply trying to stay afloat once they become troubled. Similarly, consumers fall prey to moral hazard by becoming more insensitive to insurer financial condition, for example, when they purchase insurance on the basis of price alone without regard to risk (i.e., the claims-paying ability of the insurer). Neither insurers nor consumers are penalized for their own risky behavior. In some respects, they are rewarded for it. Risky insurers can grow premiums by underwriting and pricing aggressively, while risky consumers can pay lower premiums for broader coverages.

Regulation is likewise vulnerable to moral hazard if the presence of guaranty fund protections causes oversight to be less rigorous under the presumption that losses will be restored should oversight fail. Indeed, the tendency of moral hazard to undermine market vigilance is applicable to all components of the insurance market, whether they are insurers (i.e., competitors), brokers and agents, other service providers (e.g., rating organizations, securities analysts, actuaries and auditors), consumers or regulators.[218]

217 See Ely, Bert, "Regulatory Moral Hazard — The Real Moral Hazard in Federal Deposit Insurance," *The Independent Review*, Vol. IV, No. 2 (Fall 1999) at 241.

218 See Macey and Miller (1993) at 89-90.

Intuitively, insolvencies represent the worst possible outcome and, for that reason alone, financial monitoring is a critical area of regulation that deserves the highest priority and attention. The establishment and maintenance of guaranty funds provide important benefits by serving to reinforce market confidence and stability, and help limit systemic risk not only in the insurance sector, but within the entire financial system.

From a purely economic standpoint, however, guaranty funds achieve these important goals at very high costs. As with other regulatory actions, the direct costs of guaranty funds (i.e., assessments, net payouts and administrative expenses) are large and draw most of the attention. In contrast, the distortions and other indirect costs that result likely are far more substantial yet more prone to be overlooked because they are relatively difficult to measure and attribute.

By spreading the cost of losses among parties not directly involved in the transactions giving rise to those losses, guaranty fund protections produce significant externalities.[219] As was the case with regulated exit barriers, guaranty fund protections anomalously seek to alleviate one or more *potential* market failures that contribute to insolvencies (e.g., information constraints and principal-agent conflicts) by imposing an alternate but more *definitive* market failure (i.e., externalities).

When coupled with corporate personal liability protections, guaranty fund protections help ensure that the parties most directly responsible for the insolvency bear relatively little of its cost, particularly when multi-state insurers fail. In such cases, the parties most responsible for the insolvency are, arguably, the management of the failed insurer and its domiciliary regulators. Yet, the costs of the insolvency are borne primarily by others — i.e., the *shareholders* of the failed insurer, as well as all the insurers, policyholders and taxpayers located not only the domiciliary state, but also in all the other states in which the failed insurer wrote business.[220]

By shifting the burden to other policyholders and taxpayers, the guaranty funds also effectively shift normal loss control incentives (in this case for monitoring the insurer) to these parties as well. Ultimately, policyholders and taxpayers who have no relationship with the insurer have equal or greater incentive to monitor the insurer as its own policyholders. The same incongruity is evident in the exclusion of large commercial insureds and high net worth parties from guaranty fund protections. Since these parties are presumed to be able to afford unfunded losses, they are penalized by having their loss control incentives *raised*. Meanwhile, those who cannot afford such losses and, therefore, should be more sensitive to insurer solvency, are rewarded by having their loss control incentives *lowered*.

Left to run its course, this mechanism tends to produce a bifurcated market whereby those with normally low loss control incentives gravitate toward the strongest, most solvent insurers (i.e., those that underwrite conservatively), while those with normally high loss control incentives gravitate toward the weakest, riskiest insurers (i.e., those that underwrite aggressively). This is contrary to market functioning and likely results in greater overall loss costs, if not greater insolvencies.

The direct costs of insolvencies and guarantee fund protections are relatively straightforward to evaluate. For property/casualty lines, since the inception of the state guaranty funds in 1969, net assessments on the industry have totaled $6.6 billion through 1999.[221] Breaking this period into decades, annual assessments averaged $17 million in 1969-1979 (11 years), $282 million in 1980-1989, and $325 million in 1990-1999.[222]

219 One caveat is relevant here. While other parties may bear the cost of insolvencies without being directly involved, they receive some value in return — i.e., similar protections in the event that their coverages fail. The same is not true, however, for consumers who are exempted from guaranty fund protections.

220 Shareholder equity investments are not covered by guaranty fund protections. Insurers are affected initially by guarantee fund assessments, but are permitted to recoup assessment costs from their policyholders through future premium surcharges and/or from taxpayers via offsetting credits to their state premium taxes. The costs of any unreimbursed assessments are also transferred to taxpayers via permitted federal income tax deductions. See Feldhaus and Klein (1998) at 48-49 and Klein (2000) at 58, both citing Barrese, James and Jack M. Nelson, 1994. "Some Consequences of Insurer Insolvencies." *Journal of Insurance Regulation*, 13: 3-18.

221 See National Conference of Insurance Guaranty Funds (NCIGF), *Assessment and Financial History Reports*.

222 IBID. In the five-year period leading up to the 1989-1990 investigation by the House Committee on Energy and Commerce headed by John Dingell, assessments averaged $577 million per year. Since then, assessments have not reached that level again in any year, even in the 1993-1995 period when they were inflated by special assessments related to the numerous insolvencies caused by Hurricane Andrew.

The states limit annual assessments in a range of one to four percent of covered premiums, with most states utilizing a cap of two percent.[223] In actuality, annual assessments nationwide have averaged less than 0.3 percent of covered premiums historically.[224] For life, health and annuity lines (generally administered separately), assessments called since 1988 have totaled $5.6 billion, or an average of $465 million per year.[225]

Thus, the direct costs of insolvencies are fairly modest relative to total premiums, averaging $865 million per year over the last decade. In contrast, the indirect costs, while immeasurable, are substantial. As noted, the overall distortion in loss-control incentives not only increases insolvencies, but increases losses overall, including those that are covered and paid by all the insurers that remain solvent. Given that loss claims total several hundred billion dollars each year, even a modest reduction in such incentives have the potential to generate additional loss claims that dwarf the direct costs of regulating insolvencies and providing for guaranty fund protection.

There are numerous other problems cited with respect to solvency regulation and guaranty funds that cut across both scope/conduct and structural weaknesses in the current system, although none is as significant as the moral hazard problem and the potential for generating externalities. Examples of other scope problems include the lack of a risk-based adjustment in assessments (which would offset some of the moral hazard problem) and arbitrariness in eligibility and benefit standards.[226] Structurally, the major weaknesses pertain to the lack of uniformity in eligibility and benefits, the limited capacity of individual state funds and their lack of cost sharing provisions among other states, and general coordination issues.[227] While these problems are important and potentially correctable through alternative structures, structural changes alone may be insufficient to remedy the adverse effects arising from externalities and cross-subsidies, or the distortion in loss-control incentives.

223 See Feldhaus and Klein (1998) at 48. Annual assessments can be omitted if the state fund has sufficient unused capacity to meet guaranty fund payments.

224 IBID.

225 See National Organization of Life and Health Insurance Guaranty Associations (NOLHGA).

226 See Macey and Miller (1993) at 86-87.

227 See Feldhaus and Klein (1998) at 49-50.

VIII Additional Market and Reform Considerations

A. INTERSTATE MARKETS

As outlined previously, the industry's primarily state-based regulatory structure developed when insurance markets largely were localized to state jurisdictions. As insurance markets expanded alongside the economy at large, the development and regulation of insurance was kept functionally distinct from other financial services. Today, some of those elements remain, while others have been discarded or fundamentally changed. The insurance industry has internally segmented along numerous dimensions from different lines of coverage to the types and size of its customers. At the same time the industry has splintered into specialized niches, it has also internally consolidated.

The fundamental rationale for the state-based regulatory structure is the desire to address particular needs and preferences of discrete state markets. Setting aside the multitude of other factors shaping the industry and challenging the regulatory structure, it is instructive to test how strong this foundation remains today. While state regulators may continue to have strong preferences for local control, do market dynamics still support this segmentation along state lines? If not, then the maintenance of a state-based regulatory structure under these conditions will be prone to generating a number of distortions and inefficiencies. In fact, the state-based regulatory structure not only might be distorting and inefficient, but also might be institutionalizing state differences that are no longer relevant and, therefore, hindering the development of a broader national market.

A relatively straightforward method of testing this foundation is to analyze each state's market and determine empirically how much business is written by insurers domiciled in that state. If state markets remain largely discrete, then insurers will tend to write a large proportion of their overall business within their state of domicile. Alternately, the number of domestic companies in each state can be compared to the total number of companies conducting business in that state. Once again, if state markets remain largely discrete, then domestic companies should comprise a large proportion of the total number of companies conducting business in each state.

This analysis was undertaken in a previous study using annual NAIC data tapes from the financial statements filed each year by insurers.[228] While the data are from 1995, the general findings are still applicable today, although there likely have been some changes and shifts in the interim. The relevant information is summarized on the following page.

These data support the following conclusions:

- On average only 21 percent of property/casualty premiums and 12 percent of life/health premiums in each state are written by domestic companies. Thus, a substantially higher volume of premiums are written by *foreign* companies (i.e., 4 to 8 times *higher*) in each state than by *domestic* companies.

- Within each state, there are a far greater number of *foreign* companies conducting business than *domestic* companies. For property/casualty lines, there is an average of 16 *foreign* companies conducting business in the state for each *domestic* company, while the ratio is nearly 30:1 for life/health lines.

228 See Grace and Phillips (1999) at 8-9, Table 1-2.

INTER- OR INTRA-STATE MARKETS?

MEASURE	PROPERTY/CASUALTY	LIFE/HEALTH	TOTAL PREMIUMS
PERCENT OF STATE INSURANCE PREMIUMS WRITTEN BY DOMESTIC COMPANIES			
AVERAGE, ALL STATES	21.3%	11.8%	16.6%
MINIMUM, ALL STATES	1.8%	0.0%	1.4%
MAXIMUM, ALL STATES	57.2%	48.5%	38.0%
RANGE OVER 1 STANDARD DEVIATION	8.2% – 34.4%	0.1% – 23.5%	6.7% – 26.5%
PROPORTION OF INSURERS DOMICILED WITHIN EACH STATE			
AVERAGE, ALL STATES	6.3%	3.4%	4.9%
MINIMUM, ALL STATES	0.2%	0.0%	0.2%
MAXIMUM, ALL STATES	25.8%	21.4%	21.4%
RANGE OVER 1 STANDARD DEVIATION	0.4% – 12.2%	0.0% – 7.3%	0.2% – 9.6%

- While all lines have a low *intra-state bias*, the bias is distinctly more pronounced in life/health lines than property/casualty lines. In other words, property-casualty lines exhibit more of a local concentration than life/health lines.

- Larger market states are more likely to have a stronger *intra-state bias* than smaller market states. In other words, domestic companies tend to account for a greater proportion of the overall business conducted in larger market states than in smaller market states.

These data have important implications regarding the regulation of the industry. As the scope of the market becomes increasingly interstate or national, structural limitations of the state-based regulatory system potentially become more problematic. While each given state assumes primary responsibility for its domestic insurers, it increasingly relies on the other states to regulate the foreign companies that account for the majority of the business conducted within that state. Similarly, while each given state retains primary oversight of its domestic companies, the majority of the business conducted by those companies occurs in other states.

Thus, through its reliance on domiciliary states as primary regulators, the state system's tendency to generate externalities is magnified, as *spill-over* and *free-rider* effects become more pronounced. In addition, each state's jurisdictional reach becomes more limited as the market becomes increasingly interstate in scope, thereby increasing the need for coordination and comity among the states.

Finally, given their stronger intrastate bias, the larger market states would be expected to be less receptive to efforts to increase uniformity and reciprocity, or generally undertake any regulatory reforms geared to improving market efficiency and functioning. With the benefit of a large market in which its own domestic companies have a relatively high degree of participation, such states may be less driven to undertake reforms to make their markets even more attractive. The size of their markets alone is sufficient to attract both domestic companies as well as foreign companies. In contrast, smaller market states tend to have much lower participation by domestic companies due to size and scale considerations and, therefore, are more likely to undertake reforms to make their limited markets as attractive as possible. This suggests that regulatory competition among the states may be somewhat limited as smaller states tend to take the lead while larger states are content with the status quo, or may even resist efforts to increase uniformity and efficiency.

As discussed in greater detail below, this polarity between large and small states with respect to reforms is evident in the producer licensing initiatives undertaken following passage of GLBA. The states that have resisted enacting fully compliant legislation have tended to be among the largest markets in the country. The experience to date suggests that seeking reciprocity as a stepping stone toward uniformity may be misdirected, as the lack of complete uniformity (even if improved) ultimately undermines the states' willingness to grant and accept full reciprocity. Moreover, since the degree of willingness of the states tends to be inversely proportional to market size, efforts to increase reciprocity without uniformity will tend to be undermined by reduced participation by the largest markets, whose absence seriously degrades the potential benefits of such efforts.

B. GLOBALIZATION AND FOREIGN TRADE

International trade and globalization will continue to grow in importance for the industry due to two prevailing trends. First, international trade in both goods and services generally continues to expand both broadly and quickly. This is a product of many factors, but is particularly a result of increased market access and transparency. These prerequisites for effective foreign market penetration are, in turn, becoming better established and protected by virtue of the entrenchment of the World Trade Organization, with its ever-expanding membership and trade protections, as well as the proliferation of bilateral and multilateral trade agreements.[229]

Second, trade in financial products is being greatly facilitated by the growth and development of electronic commerce, which can significantly reduce barriers to entry and operating costs for such products.

It has been suggested that the existing state regulatory system in the United States acts as a potentially illegal barrier to trade and will frustrate efforts to expand into foreign markets. While this is true to an extent, certain extenuating factors should be considered, as follows:

- First, the United States is, by far, the largest insurance market in the world. Several individual state markets are larger than most other national markets around the world.

- Second, while the state system may hamper entry to a degree, substantial evidence is lacking that these entry barriers discriminate against foreign companies vis-à-vis domestic companies. In many respects, the U.S. system may be no more burdensome than other country markets. Provided that there is no differential treatment of U.S. and foreign insurers in the U.S. market with respect to regulatory matters, foreign insurers do not have a strong cause for complaint. The relevant criterion is not whether the U.S. market is more or less open than its trading partners, but whether U.S. regulators discriminate against foreign companies.

- Third, there is significant participation in the U.S. market by foreign companies, indicating that any entry barriers and other regulatory hurdles are navigable. The next largest world market — Japan — has negligible foreign participation.

- Fourth, arguably the separation of the financial services segments posed a much more significant barrier to trade than the state system, and that separation largely has been addressed by the Gramm-Leach-Bliley Act.

229 While the United States has completed and continues to pursue additional free trade and other trade liberalizing agreements, it has generally lagged behind many other developed countries in the rest of the world. There is evidence that the United States is moving to avoid falling further behind, although economic turmoil in the Western Hemisphere outside North America (the logical starting point for such expansions), as well as political difficulties in obtaining the so-called "Fast Track" authority believed to be instrumental in completing such agreements, has slowed the process.

One potentially favorable effect of increased foreign participation in the U.S. market is that it adds interest groups that might increase pressure on state regulators to enact reforms to improve the efficiency of regulation. On the other hand, the federal government has typically maintained a strong deference to states' rights in trade negotiations and related affairs. Often, the lack of strong political support or presence of controversy regarding trade agreements and other negotiations tend to limit the federal government's willingness to pressure the states in the context of trade agreements and negotiations.

C. EXCESS AND SURPLUS LINES

For many reasons, the excess and surplus (E&S) lines reflect a microcosm of the many regulatory and efficiency issues relevant to the broader insurance market and industry. Depending on the perspective, the E&S market can be seen as the bridge between the admitted and alternative markets, or, as the market of last resort that accepts risks that are declined in the primary market. Like alternative markets, E&S lines reflect, in part, the purposeful avoidance of regulation by the industry and consumers, and the increasing loss of direct regulatory control by state regulators.

E&S lines exhibit many interesting characteristics of interest that could be useful in evaluating the possible effects of less or differently structured regulation under alternative systems.

- The improvements stemming from less or more efficient regulation in terms of many important market parameters — stability and solvency, product innovation, speed and flexibility in responding to market demands, underwriting and investment portfolio performance, and customer satisfaction.

- The significant difficulties and inefficiencies stemming from even the reduced level of regulatory control that is exercised over E&S lines, including variations in state eligibility and licensing criteria, diligent search requirements, and the collection and remittance of premium taxes.

- The creation of distortions through structural distinctions between E&S lines and either admitted voluntary or residual markets that parallel the distortions noted previously between voluntary and residual markets. In addition, restrictions on E&S lines can limit the ability of insureds to obtain the coverages they desire and are willing to purchase, as often occurs with product form regulation.

- E&S lines have a significant self-governing dynamic that is administered via the National Association of Professional Surplus Lines Offices (NAPSLO), as well as individual state stamping offices, which help regulate solvency, eligibility and qualifications, tax collection, information gathering and dissemination.

It should be noted, however, that although regulatory oversight of E&S lines is reduced overall, a substantially larger portion of the reduced regulatory burden is borne by brokers, who serve as a primary leverage point for regulatory contact. This has important implications in connection with the broader deregulation effort being undertaken among traditional regulated lines. As the market moves toward greater deregulation, there may be a temptation to shift or assign greater regulatory responsibilities to agents and brokers as has been done in E&S lines.

The transfer of regulatory responsibilities from regulators to agents and brokers is misguided from several perspectives. First, agents and brokers face their own difficulties in adjusting to the fast-moving and competitive market that need not be complicated by increased regulatory responsibilities that are better handled by regulators. Agents and brokers' role in the market place is expanding rapidly as they assume more and more functions that were previously handled by insurers, outside consulting firms or other financial services companies. At the same time agents and brokers are expected to perform these wide-ranging and additional services, they are not receiving additional compensation from insurers and are facing a sharp increase in competition from both traditional and nontraditional sources that include insurers and reinsurers that are writing premiums directly, banks, accounting organizations and investment houses.[230]

Second, while agents and brokers play a vital role in assisting their clients to obtain and understand the information needed to complete insurance transactions, the actions of insurers are beyond their control. Unlike regulators, agents and brokers lack the means and the ability to compel disclosures by insurers or intervene in the operations of insurers, making them inappropriate substitutes for direct supervision by state regulators or even as ancillary leverage points for regulatory control.

Agents and brokers are neither designed nor equipped to make financial and solvency judgments either on an absolute basis or in relation to state regulators and other market participants. Relying on them to do so likely will decrease regulatory efficiency *and* effectiveness. In the context of the market failures discussed previously, such a role places agents and brokers in the middle of the principal-agent conflicts between insurers and consumers. These conflicts are inevitable and agents and brokers serve an important role in helping to mediate and minimize them. The addition of explicit regulatory responsibilities, however, will hamstring agents and brokers in that role, to the detriment of consumers and overall market functioning, since they lack sufficient capability to undertake such responsibilities.

D. REFORM CONSIDERATIONS

The industry faces numerous factors that rest upon a quickly evolving landscape as it contemplates its future regulation. Consequently, it is easy to become entangled in the complexity of these many complementary and often conflicting considerations. In that vein, it is import to remember that the industry should be operating from a position of strength that is derived from a competitively structured market. While excessive or unnecessary regulation causes numerous distortions and other inefficiencies, the market and its participants have shown the ability to overcome these problems, as well as the normal competitive forces they face.

1. DEREGULATION OF COMMERCIAL LINES

There is considerable evidence that many of the market failures and other problems evident in the insurance market generally apply with much less force, if at all, to the property/casualty segment, as the following quote broadly underscores:

> The property-liability insurance industry possesses the structural characteristics normally associated with the idealized competitive market: a large number of firms, operating in a market with low concentration levels, selling essentially identical products, provided at constant unit costs and with ease of entry of new and potential competitors ... It is ... difficult to find ... many other industries which conform more closely to the economist's idealized competitive market structure.[231]

230 See Schiff, Samuel. "Agency System Lives but Continued Agency Survival Will Require Adapting to Changes." *The Rough Notes Magazine*, February 1999.

231 See Joskow (1973) at 375, 391.

Accordingly, the broad deregulation effort being undertaken with respect to commercial lines is the ideal approach, as opposed to incremental changes in particular regulations or even more dramatic changes in the regulatory structure, unless changes in the regulatory structure facilitate deregulation. The extent to which NAIC and state regulators embrace deregulation could mark a departure from their more traditional approach of protecting consumers and maintaining solvency "above all else." This traditional perspective often disregards the attendant costs of achieving a nominal regulatory objective. When conditions of strong structural competition are present, as they are with respect to commercial lines, then the market will be the most effective and efficient means of moderating undesirable behavior or outcomes — such as excessive risk taking and price gouging — that regulators have tended to claim as their province.

Nevertheless, the deregulation effort, like other modernization and reform efforts, has shown susceptibility to weakness in the state regulatory system, as favorable changes in scope are undermined by structural limitations that tend to produce standards that vary significantly across the states.[232] While non-uniform deregulation is better than none, its benefits are significantly undermined by the lack of uniformity, which also hampers the achievement of improved reciprocity and comity among the states.

2. NARAB AS A LITMUS TEST[233]

A. NEED FOR ADDITIONAL PRESSURE

The state-based regulatory structure is capable of dramatic changes. NAIC's accreditation effort, for example, was a massive undertaking and accomplishment that has led to material improvements in the critical area of financial regulation. Nevertheless, it must be recognized that these changes occurred under pressure of Congressional oversight and the direct threat of federal intervention.

Unfortunately, without external pressure, reform efforts typically suffer from the same inertia that plagues the more routine regulatory activities within the state structure. With so many jurisdictions and specific or individualized preferences, reform, like licensing or form approval, easily becomes subject to long delays and complications that cause it to lag behind the industry's needs and fall short of more ideal outcomes. While the state structure has proven fairly responsive to the industry's development and evolution, history has proven time and again that there is no greater impetus than the threat of federal intervention in pushing the states beyond the proposal and limited adoption stage to achieving effective implementation of reforms.

The recent forces of market expansion (e.g., financial services convergence, electronic commerce, globalization and international trade) have increased the industry's sensitivity to regulatory frictions, particularly now that these frictions have transformed from merely unnecessary costs and inconveniences to potential competitive disadvantages and even threats to the industry's longer-term health. It is reasonable for the industry to question whether these evolutionary forces have raised the stakes sufficiently to impel the state system forward, or whether additional external pressure will have to be brought to bear to achieve meaningful and timely reforms in the future.

There are several additional voices in the market that have the potential to generate additional pressure on the states that appears necessary. Conversely, however, these voices also could serve to expand, diffuse and complicate the debate, which might engender more hesitation or delay on the part of Congress and the regulators. These new market entrants include banks and foreign companies that bring with them

232 A secondary weakness stems from partial or piecemeal deregulatory efforts in which deregulated standards are restricted to parties deemed to meet certain eligibility criteria. While establishing such criteria is necessary to administer the new standards as intended, the benefits of deregulation are offset to a certain degree by the increased burdens of making individual eligibility determinations, which may not be clear cut in many cases and, therefore, potentially arbitrary or unfair. In such cases, the adoption of a self-certification approach with regard to eligibility can significantly preserve or restore those benefits.

233 NARAB refers to the National Association of Registered Agents and Brokers.

regulatory competition that the states are already beginning to face directly. Moreover, as the market finds new and creative ways to conduct its business, the states' regulatory reach is ever-shortening, which is an obvious cause of concern for the market overall, but especially state regulators.

Finally, the complexity of markets and products is increasing while the ability to conduct transactions is accelerating and expanding, which raises the potential for significant regulatory missteps that could lead to increased federal attention, whether in anticipation of, or in reaction to, problems that might develop. Under these conditions, therefore, if the states' efforts to achieve meaningful reforms remain mired, calls for wholesale changes in regulatory structure will gain even greater traction.

B. EXPERIENCE TO DATE

Against this backdrop, the states led by NAIC are undertaking an unprecedented number of parallel reforms spanning many different areas of oversight, including the reform of producer licensing to improve uniformity and reciprocity. Since this is an area of particular interest to agents and brokers, it serves as a good litmus test of the capability of the state system to undertake needed reforms.

While the states have made significant progress in licensing reforms, at this juncture the effort nonetheless appears beleaguered by many of the traditional obstacles *even in the face of federal intervention*. As a starting point, despite its significance and importance, GLBA set the bar fairly low in relation to the broader objective of achieving a truly uniform system of producer licensing. In effect, it serves more as a catalyst than a blueprint in allowing the states considerable latitude and discretion in implementing its requirements. It provided a three-year time frame and required only 29 states to achieve compliance in order to forestall the creation of NARAB. NAIC responded by indicating on one hand that its revised model law went well beyond the minimum requirements of GLBA, while, on the other hand, that it would begin by pursuing the lesser goal of achieving the multi-state reciprocity requirements of GLBA as a more achievable and necessary first step towards full uniformity.[234]

According to NAIC, 44 states have passed legislation or adopted regulations seeking to satisfy GLBA reciprocity provisions as of May 20, 2002.[235] Accordingly, NAIC appears to have reached its interim goal of forestalling NARAB. A closer examination of the implementation to date, however, is less encouraging. The 44 states account for roughly 85 percent of the total number of states, but less than 75 percent of the total premiums written.[236] Significantly, several large market states are included within the group that has failed to pass legislation to date, including California, Pennsylvania and New York, all of which are among the top five state markets.[237] Even among the states that have passed relevant legislation, there remains some uncertainty whether such legislation is fully compliant with NARAB reciprocity requirements, as NAIC has yet to confirm compliance or there are disputes regarding the exact nature of those requirements.[238] These states represent an additional 14 percent of the market including the states of Texas and Florida, the country's second and third largest markets, respectively. This information is summarized on the following page.

While NAIC continues to work diligently to add states to the roster and several months remain until the formal deadline, it is difficult to declare victory even though the minimum requirements appear to

234 See NAIC, *Statement of Intent: The Future of Insurance Regulation*; Testimony of George Nichols III Regarding State Insurance Regulatory Modernization and Implementation of the Gramm-Leach-Bliley Act, *Before the Subcommittee on Finance and Hazardous Materials, Committee on Commerce, United States House of Representatives*, July 20, 2000. A fundamental question that remains unanswered is whether true reciprocity can be achieved without uniformity.

235 See NAIC — NARAB Working Group, *Producer Licensing Model Act Implementation*. (May 20, 2002) downloaded at http://www.naic.org/GLBA/narab_wg/PLMA.htm

236 See *NAIC, 2000 Insurance Department Resources Report*.

237 See NAIC — NARAB Working Group, *Producer Licensing Model Act Implementation* (May 20, 2002); *NAIC, 2000 Insurance Department Resources Report*.

238 See "The Council, NAIC Review State Licensing Reforms," *The Council Advocate*. (Winter 2001). The states in dispute include Alaska, Idaho, Washington and Texas. The areas of dispute include the retention of surplus lines bond requirements and fingerprinting requirements for nonresident producers. Additionally, Florida has recently enacted licensing reform legislation that will continue to require fingerprinting of nonresident producers.

SUMMARY OF U.S. LICENSING REFORMS

STATE/COMPLIANCE STATUS	2000 DIRECT PREMIUMS *(IN MILLIONS)*	PERCENT OF TOTAL DIRECT PREMIUMS	OVERALL STATE RANK
IN COMPLIANCE — 39 STATES	$549,000	57.4%	NA
NOT IN COMPLIANCE — 7 STATES	$271,118	28.3%	NA
CALIFORNIA *(NOT APPROVED)*	$88,795	9.4%	#1
NEW YORK *(UNDER CONSIDERATION)*	$84,865	6.2%	#2
PENNSYLVANIA *(UNDER CONSIDERATION)*	$58,279	6.1%	#4
TENNESSEE *(NOT APPROVED)*	$19,694	1.9%	#18
SOUTH CAROLINA *(UNDER CONSIDERATION)*	$8,440	0.9%	#29
NEW MEXICO *(NO ACTION TAKEN)*	$6,044	0.5%	#33
DISTRICT OF COLUMBIA *(UNDER CONSIDERATION)*	$5,001	1.1%	#39
COMPLIANCE IN DISPUTE — 5 STATES	$136,436	14.3%	NA
TEXAS	$63,468	6.8%	#3
FLORIDA	$51,713	6.3%	#5
WASHINGTON	$16,924	1.8%	#22
IDAHO	$3,007	0.3%	#45
ALASKA	$1,324	0.2%	#50

be satisfied. While having 39 to 44 states adopt the reciprocity requirements is an improvement over 50 different state standards, this result falls far short of a fully uniform national market. Compared to that objective, the absence of as many as 12 states comprising more than 40 percent of the market is unsatisfactory. Thus, even under the threat of federal intervention, NAIC and the states have struggled to clear the lowest rung with respect to producer licensing reforms.

Optimistically, the reciprocity measures may constitute a difficult first step that will help achieve uniformity more quickly as NAIC has posited. This could be the case if the benefits of reciprocity draw the non-compliant states into the fold, although the resistance of so many major market states does not appear to validate that dynamic. To the contrary, it suggests that due to the relative attractiveness of the market in these states, they tend to have a higher proportion of domestic insurers and producers, which, in turn, makes them less willing to cede their prerogative to license as they specifically desire. Thus, after 2- years' time with limited progress and even some disagreement as to what constitutes true reciprocity, it is reasonable to expect that true national uniformity could require many more years to achieve, if it can be achieved at all under the current circumstances.

In fairness to the states and NAIC, no conclusions should be made until the deadline passes and the outlook for achieving uniformity is more visible. Nevertheless, the view from here is not encouraging, as uniformity represents a far more ambitious goal that is not subject to any further deadline or threat of federal intervention. Additionally, NAIC and the states already have a full plate, and it is clear that the pace of new challenges — financial services convergence, electronic commerce, globalization and emerging market problems — is accelerating and could cause resources and attention to be shifted elsewhere on short notice. Until the states and NAIC demonstrate otherwise, therefore, there are valid reasons to believe that the state structure is incapable of responding quickly enough to these challenges without sufficient incentive.

1) IMPLICATIONS FOR FEDERAL MINIMUM STANDARDS

The NARAB provisions represent an example of limited federal minimum standards implemented and enforced by the states. By requiring only a slight majority of states to achieve compliance, the measure falls short of fully national standards. The experience to date, however, suggests that minimum standards are not sufficiently constraining on the states, and permits them to add ancillary, state-specific elements that frustrate goals of achieving better uniformity and reduced redundancy. Implementation and enforcement provide another avenue for additional state discretion and variation beyond the difficult task of adopting conforming legislation.

If the opportunity for individual state discretion is not foreclosed, the states have difficulty resisting the tendency to tailor minimum standards to local market concerns and objectives. Thus, the application of minimum standards appears to be better geared toward improving the conduct and effectiveness of regulation rather than making it uniform and less redundant.

2) IMPLICATIONS FOR NAIC EMPOWERMENT

Two key shortcomings of the current state system under conditions of reform are NAIC's lack of authority and the resulting tendency of the individual states to modify and expand specific regulatory requirements thereby preventing the establishment of more uniform standards.

NAIC performs much of the "heavy lifting" by mediating individual state differences in framing reasonable compromises in the form of model laws. Due to its lack of authority, the success of its efforts is ultimately dependent upon the willingness of the states to adopt NAIC's concepts of uniformity and reciprocity, which has proven to be limited and variable. In the interest of achieving a broader consensus, there is an inherent tendency in the model law process to follow one of two extremes — either to dilute the relevant standards to avoid imposing any new requirements on any individual states (i.e., least common denominator) or to raise those standards to the highest possible level in order to ensure that the states with the most rigorous requirements need not fear any diminution in the quality of their oversight (i.e., highest common denominator).

With the least common denominator approach, achieving a consensus is easier but of less value since individual states will adopt additional requirements as they see fit. With the highest common denominator approach, achieving a consensus is much more difficult and runs the risk of significantly increasing the overall scope of oversight. Thus, it is not clear that either approach provides sufficient incentives to individual states or adequate outcomes to regulated entities.

NAIC's ambitious and generally well-received accreditation program provides a good example of this mechanism in practice. As an initial matter, there is no apparent substantive reason why this program cannot be applied to other areas of regulation. If NAIC was able to achieve adoption of accreditation standards in the relatively critical, complex and sprawling area of solvency regulation, there seems to be no valid reason why this approach cannot work in other relatively less critical and simple areas such as producer licensing.

While the accreditation program is far from perfect and still lacks complete "participation" after 10 years in existence, the program did manage to galvanize the states in a manner that was clearly lacking prior to the program. Two factors have been identified as keys to the success of the accreditation program, which are instructive should this approach be applied to other areas such as producer licensing: 1) centralization of the review of regulatory data (but not enforcement); and, 2) the states seem more willing to accept uniform standards if they are more stringent and improve the quality of oversight, rather than reduced standards that are more directed toward improving the efficiency of oversight.[239]

With regard to the first factor, NAIC essentially facilitates the review by state regulators by collecting the relevant information centrally and then performing preliminary analyses ("IRIS" and "FAST" ratio

239 See GAO (2001) at 5-6, 8.

analysis) that are reported back to the domiciliary state for further review and enforcement.[240] The dynamic is that NAIC shares rather than assumes responsibility for oversight with the states and does so by using regulatory tools and performing analyses that the states cannot do on their own. These same considerations are present with respect to producer licensing. NAIC is able to centrally collect information on a national basis that an individual state cannot easily obtain on its own. Moreover, NAIC brings certain regulatory tools to the process, namely its Producer Database and Producer Information Network, that the states lack. There seems to be no reason why NAIC could not serve as a central repository where producer licenses are first screened and reviewed before being passed onto the states for further action.

With regard to the second factor, improving the stringency rather than the efficiency of regulatory standards is where the case for producer licensing is weaker. While there certainly is potential for uniform licensing standards to improve the conduct of oversight in this area, the focus primarily has been on improving the efficiency of such oversight by reducing redundancies and state-specific requirements. Consequently, the effort to "streamline" producer licensing might be met more receptively if the benefits to the quality of such oversight were emphasized as opposed to its efficiency benefits.

While NAIC seems to be positioning itself as a potential future regulatory authority, from a structural standpoint, empowering NAIC could be similar to inserting a new federal regulator or making it the source of minimum or explicit national standards that are left to the states to implement, the shortcomings of which were discussed above. As it stands, NAIC merely suggests minimum standards to the states without true authority, but derives some leverage by offering ancillary services and support in conjunction with the adoption of such standards.

3) IMPLICATIONS FOR INTERSTATE COMPACTS

The idea of using interstate compacts continues to be debated in the context of several different regulatory areas. This structure has been tried on a limited but not particularly successful basis with respect to receivership administration and is currently under consideration by NAIC in terms of implementing its Coordinated Advertising Rate and Form Review Authority (CARFRA) initiative. The major obstacles to this structure include the unwillingness of individual states to cede authority to the designated compact commission or to adopt identical laws.[241] Other criticisms include that the structure fails to achieve uniformity, maintains inefficiencies and redundancies in administration, and that business is not written on the basis of proposed compact regions.[242]

While these are all valid points, they also are applicable in even greater force to achieving broader uniformity and reciprocity on a national basis. If states are unwilling to cede authority to a regional compact (from which they can withdraw easily), then it does not seem likely that they would readily submit to a national authority or to national standards unless compelled. Similarly, if a finite group of geographically proximate states is unwilling to adopt identical laws, the prospects of 50 different states doing so must be considered more remote.

Thus, while segmenting the market into four to six compact regions does not fully address uniformity and redundancy concerns, it certainly marks an improvement over 50 different state jurisdictions. The compact structure represents a compromise or an interim step that enables states to test uniformity and reciprocity on a limited and trial basis. If successful, individual compacts could then be merged in moving toward a national market in discrete steps rather than all at once. While this is certainly less ideal than moving directly to uniform national standards, as well as subject to other difficulties, individual states may be less resistant to an incremental approach.

240 IBID.

241 See Reinsurance Association of America. "Interstate Compacts." *Policy Update*.

242 IBID.

In the context of the current reforms, the number of states unwilling to comply with the NARAB reciprocity provisions raises two points. First, in the pursuit of national standards, if a sufficient number of states (particularly large market states) are unwilling to participate, then the effort ends up producing a compact-like structure, albeit a distinctly imbalanced one. At this time, there are 35 to 39 states willing to grant reciprocity, potentially resulting in one large jurisdiction and 12 to 16 additional ones that are dominated by larger market states. Second, the concentration of larger market states in the non-complying group suggests that these states strongly prefer to exercise more discretion over their own markets. If individual compacts were oriented around these large market states, then they might be more willing to participate under the assumption that, by virtue of their large market size, particularly in relation to the regional compact, they would tend to exert leadership within that regional compact.

IX

Principal Views and Recommendations

A. GENERAL CONSIDERATIONS

- Regulation is inherently more oriented toward its outcomes — solvency and consumer protection most importantly — than its processes and secondary effects. A more holistic and empirical approach forces closer consideration of regulatory processes and their secondary effects, which can be costly and distorting.

- The indirect and unintended effects of regulation often are adverse and undermine the benefits accruing from the achievement of stated regulatory goals, or frustrate the achievement of those goals altogether.

- At the very minimum, alternative regulatory structures must demonstrate adequate performance on the core regulatory objectives of solvency and consumer protection. Most of the potential efficiency gains, however, will come from improved performance in the secondary or peripheral areas of regulation (e.g., licensing and rate and form approval), ideally by reducing the scope of regulation (deregulation) rather than by re-engineering existing processes.

- While agents and brokers may be affected uniquely or discretely by regulation vis-à-vis other segments of the industry, the regulatory structure that best serves the industry as a whole likely will prove optimal for agents and brokers as well. While agents and brokers play a key role in the market by helping to mediate and minimize conflicts between insurers and consumers, as well as reduce information constraints on both sides of insurance transactions, they are neither designed nor equipped to undertake direct regulatory responsibilities for either insurers or consumers. Transferring such responsibilities to agents and brokers will decrease the effectiveness and the efficiency of regulation.

B. COST CONSIDERATIONS

- The indirect costs of regulation (market efficiency and distortions) are, by far, the most significant of the different types of regulatory costs. For the most part, these costs are a function of regulatory *scope* and *conduct*, rather than regulatory *structure* per se. If the existing regulations were transferred to a different structure, many of the indirect effects would persist unless the change in structure also led to changes in scope and conduct.

- While difficult to measure and assess, these indirect costs should take priority over direct regulatory expenditures and industry compliance costs in evaluations of alternative structures due to their far greater significance. The industry, consumers and regulators would benefit if these costs were more visible and quantifiable.

- The industry's direct compliance costs are substantial in absolute terms, but much less significant in relation to industry profits and premiums. Industry compliance costs likely are driven more by excessive and distorting regulation (in terms of scope and conduct) than merely inefficient or redundant regulation. Structural reforms by themselves will not reduce excessive and distorting regulation unless they involve changes in the scope and conduct of regulation generally.

C. POLICY/PERSPECTIVE CONSIDERATIONS

- The market has the inherent capabilities of performing its functions much more efficiently and competently if permitted, while still remaining within the bounds of effective regulation.

- Both regulators and politicians have demonstrated increased awareness of the fact that unnecessary regulatory distortions, frictions and costs have become less tolerable to the industry given the competitive and fast-changing market conditions in which it is operating. These factors have been transformed from being costly and inconvenient to potential competitive disadvantages that threaten the long-term health and performance of the industry.

- While it is important to distinguish between scope and structure, it is also important to recognize their interrelationships. Structure becomes more determinative of scope under conditions of change or reform, as is the case currently. Similarly, problems that arise due to the scope of regulation can be magnified by the structure of regulation.

- The hallmark of an efficient and competitive insurance market is one that minimizes the overall cost of risk, which is comprised of the cost of losses, the cost of loss control and the cost of risk transfer. Efficient markets are more focused upon minimizing costs and maximizing benefits overall than in mediating the incidence of those costs and benefits. In contrast, regulation often seeks to alter the incidence of those costs and benefits, sometimes to the detriment of overall market welfare.

- An increasing proportion of insurance transactions is migrating beyond the reach and direct control of state regulators to alternative markets and other non-traditional risk-financing mechanisms, with little evidence of adverse ramifications. This shift has important implications regarding the cost/benefit profile of regulation, whether information constraints still constitute a legitimate market failure, whether such constraints can be overcome by the industry and consumers, and whether the overall system faces greater or lesser risk as a result of this migration.

- The operating environment is being transformed by financial services convergence and modernization, e-commerce and globalization, all of which have accelerated and sharpened competitive forces. Under these conditions, the costs of regulation are magnified, particularly given their potential to produce significant disadvantages vis-à-vis new domestic and foreign competitors (or products) that are not subject to the same regulatory constraints. While this applies to the costs of even minimally necessary regulation, it is most relevant when regulatory constraints begin to impose significant burdens and inefficiencies without attendant benefits or even suitable underlying rationales.

- The tendency of insurance regulations to produce distortions and other unintended effects, regardless of the structure in which they are administered, can generally be attributed to two fundamental causes — the undermining of competitive market forces that generate incentives for loss control and the interference with the normal relationship between premium levels and expected loss costs.

- Thus, regulations that interfere with incentives for loss control or with the relationship between expected loss costs and premium levels go far beyond the basic rationale for regulation — to correct or minimize market failures. In fact, such regulations tend to exacerbate if not promote market failures, and increase the overall cost of risk to the overall economy.

D. CURRENT STRUCTURAL CONSIDERATIONS

- The limitations of traditional regulatory structures under current competitive conditions have tended to increase jurisdictional and functional disputes among the regulating agencies and other authorities as they compete to either protect their turf or try to reestablish clear dividing lines among their responsibilities. In addition, however, regulating agencies and authorities are recognizing the need for a more flexible and holistic approach to regulating financial services that relies more on cooperation, information exchange and shared responsibility. Regardless, the continuing trend toward convergence in financial services has shifted the burden of adjustment to the regulators.

- As the insurance industry becomes less functionally distinct and more national and international in breadth, interim and incremental improvements in regulation along traditional functional and geographic lines may prove to be only temporarily palliative. Even worse, limited reforms may tend to further entrench structures and practices that may not be suitable or optimal for the industry in its new competitive environment.

- Two of the primary rationales for maintaining the state regulatory structure of insurance are its abilities to tailor products and services to unique state market conditions and requirements, and to offset consumer information problems and deficiencies. These advantages are offset by inefficiencies related to redundancies and diseconomies of scale that are characteristic of decentralized authority.

- The state-based structure's primary weakness may be its susceptibility toward generating negative externalities. Consequently, assessments of alternative structures must address this issue and the extent to which this particular susceptibility can be reduced or minimized. A related problem concerns geographical limitations within the state structure, which often require that regulatory determinations be made on a state-by-state basis. It is uncertain whether such state-specific analyses are meaningful in an increasingly national and international market.

- Congress has focused repeatedly on the industry's solvency problems, citing numerous and persistent examples of ineffective solvency oversight by state regulators as prime factors. State regulators have been quick to respond by undertaking reforms and other actions to avert direct federal involvement. Nevertheless, past insolvencies have raised the question of whether regulators can identify company-specific problems, such as aggressive pricing and the understatement of reserves, on a reliable and sufficiently early basis. Corollary issues include concerns regarding the regulatory reach and expertise of regulators with respect to foreign markets and insurers, nontraditional markets and products and reinsurers (who play a relatively low profile but key role in market functioning).

- All of the major reforms accomplished under the existing state structure have occurred only in response to major external threats of federal intervention or wholesale dislocations in the regulated markets. Based on these precedents, there is no assurance that the state-based system will enact meaningful further reforms absent a significant level of continuing threat and pressure. The experience with NARAB and producer licensing to date supports this conclusion.

- The imposition of minimum standards within the existing state system could potentially improve uniformity. There is considerable evidence, however, that when these standards are set relatively low or when they continue to permit significant state discretion and variation, much of the potential benefits are undermined. There also is increasing evidence that the lack of uniformity among the states acts as a shaky foundation for improvements in reciprocity.

- Regardless of whether the states undertake significant further reforms, the inexorable trend seems to lead away from continued state regulation. If states fail to undertake significant reforms, the state system will become increasingly unsuitable to the current environment and generate tremendous pressure for wholesale change. If, on the other hand, the states undertake significant reforms and achieve a greater degree of uniformity, reciprocity and comity, those reforms will help set the stage for a further move toward federal regulation. Nonetheless, the state structure will remain under pressure whether the states move ahead or obfuscate.

E. ALTERNATIVE/FUTURE STRUCTURAL CONSIDERATIONS

- The optimal regulatory structure must meaningfully address the most problematic regulatory areas identified — primarily company and producer licensing as well as rate, risk classification and form regulation — even though these are less critical areas than solvency and consumer protection. Regulatory conduct in these areas is generally excessive, inefficient and often ineffective, if not harmful, to market functioning. In this context, deregulation likely is preferable to lesser reforms, even though the latter may constitute a necessary interim step.

- Convincing support for one structural alternative or another must be characterized by an improvement in regulatory effectiveness as a threshold matter, particularly given the growing indications that the current structure may lack the capacity to manage its functions adequately, particularly under adverse business conditions.

- In evaluating alternative regulatory structures, the industry is advised to give greater weight to alternatives that facilitate deregulation rather than those that facilitate specific changes in existing regulations. In theory, a more dramatic change in structure offers the *potential* for more rapid and extensive deregulation on a wholesale basis. While the state structure has shown it can achieve deregulation, it tends to occur on a non-uniform and piecemeal basis. Moreover, such efforts have been most successful under the threat of federal intervention.

- Universal options and regulatory perspectives — the net benefits of each of the regulatory alternatives (including maintaining the existing system) would tend to be maximized if the alternative incorporated certain universal options or approaches that are not specific to each structure. These include broader versus narrower application of changes and participation by regulating entities, the degree of self-certification or self-regulation permitted, the reorganization of regulation along distinct product or consumer segments and the adoption of prescriptive versus prudential approaches to regulation more generally.

- Any alternative that reduces the number of potential jurisdictions (e.g., interstate compact, mandatory or optional federal regulation in any form, or financial services super-regulator) has the potential to achieve rapid or wholesale deregulation, as well as improvements in uniformity (or even make uniformity cease to be an issue).

- The Gramm-Leach-Bliley Act, while offering significant near-term regulatory improvements, also has set the industry upon a potentially conflicting course in the longer-term. While the Act simply synthesizes and embodies a number of forces already at work, it likely will trigger further changes in the financial services industry as a whole that will continue to strain the regulatory structure. The Act encourages less functional differentiation within the industry while maintaining functionally distinct oversight. Without further changes, maintaining functional regulation as the industry continues to converge, integrate and globalize will produce many of the same problems as maintaining state regulation in an increasingly interstate and even international market.

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