STATEMENT OF
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PERSPECTIVES ON INSURANCE REGULATION

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Good afternoon Mr. Chairman and members of the Committee. My name is Scott Harrington, and I am pleased to provide my perspectives on insurance regulation. During my 28-year career in academia, much of my research has focused on the economics of insurance markets and insurance regulation. Many of my publications have dealt specifically with insurance rate regulation, with solvency regulation, with the performance of state regulation, and with possible federal intervention in insurance regulation.

In the early 1990s I published two papers dealing, respectively, with insolvency problems in the property/casualty and life/health insurance sectors. I concluded that federal regulation of insurance would not be an appropriate response to those problems. In 2002 I wrote a monograph for the Alliance of American Insurers on possible optional federal chartering and regulation of property/casualty insurance companies. I concluded that optional federal chartering was not justified at that time.

Earlier this year, I prepared an issues paper on possible federal intervention in insurance regulation for the Networks Financial Institute, on which much of this statement is based. Despite a number of positive and incremental reforms in state insurance regulation during the past decade, I highlighted that several key aspects of state insurance regulation, including regulation of rates, rate classification, and policy forms, remain substantially dysfunctional in many states – with no end in sight and with significant burdens on interstate commerce. I concluded that a transformation of insurance regulation was necessary to promote healthy price and product competition and to eliminate regulatory micromanagement of price and product decisions, and that such transformation could not be achieved without federal intervention.

In the remainder of my statement I will first elaborate on the key shortcomings in state insurance regulation. I will then turn to potential benefits, risks, and design issues for optional federal chartering. I will also briefly discuss alternative modes of federal intervention that might redress state regulation's problems without creating a federal regulator.

State Regulation's Performance

The economic rationale for government regulation of business activity is to protect the public interest by efficiently mitigating market failures. Regulation should only be undertaken if there is a demonstrable market failure compared to the standard of a reasonably competitive market and there is substantial evidence that the benefits of regulation will exceed its direct and indirect costs. Economically efficient regulation also requires matching the appropriate regulatory tool to the specific market failure.

Given the competitive structure of most modern insurance markets, the main economic rationale for regulation of the insurance business is to cost-effectively reduce the extent to which insurance companies or intermediaries misrepresent what is being promised at the time of sale, or fail to keep their promises through insolvency or deficient claims settlement. Achieving that objective requires regulatory oversight of insurance company solvency. It also favors some regulatory oversight of sales and claim practices to supplement competitive market discipline and contractual and tort liability remedies for fraud, misrepresentation, and breach of contract.

In contrast to the early 1970s and early 1990s, the current debate over insurance regulation has relatively little to do with solvency regulation. The main characteristics of state solvency regulation – regulatory monitoring, controls on insurer risk taking, risk-based capital requirements, and limited guaranty fund protection – are sensible given the economic rationales for regulating solvency and for partially protecting consumers against the consequences of insurer default. Having regulators in an insurer's state of domicile play a lead role in solvency regulation reduces duplication in effort and cost. A significant degree of coordination and uniformity among the states has been achieved through the National Association of Insurance Commissioners (NAIC), including through its promulgation of financial reporting requirements and its solvency regulation certification program.

The state guaranty system of limited, ex post assessments to pay a portion of insolvent insurers' obligations is appropriate and has worked reasonably well, despite a large increase in required assessments this decade. Systemic risk (the possibility that failure of one insurer or rumors of trouble could produce a run that would adversely affect otherwise solvent insurers) is significantly smaller for insurers, especially property/casualty insurers, than for commercial banks, thus reducing the need for comprehensive guarantees. Limited guaranty protection helps reduce the moral hazard problem, whereby guarantees reduce policyholders' incentives to buy coverage from safe insurers. Ex post assessments avoid the accumulation of funds that could be appropriated by legislatures for non-insurance purposes. Compared with pre-funding, the responsibility for assessments also could increase incentives for financially strong insurers to press for effective solvency surveillance and efficient liquidation of insolvent insurers.

There are two broad problems, however, with other aspects of state insurance regulation. First, too much time and money are wasted on administering and complying with diverse regulations across the states, which often are either unnecessary or deal with activities that are amenable to less oversight, less bureaucracy, and much more uniformity across jurisdictions. Second, insurance regulation is often used for political ends to redistribute income among insurance buyers. These redistributive activities generally are economically inefficient, and they typically are opaque to the public.

There are four specific issues with state regulation's performance:

1. Costs and delays associated with regulatory approval of policy forms in 51 different jurisdictions

2. Costs, delays, and possible short-run suppression of rates below costs associated with regulatory approval of insurers' rate changes

3. Restrictions on insurers' underwriting (risk selection) decisions and risk classification systems

4. State mandates that insurance policies provide coverage for certain types of benefits or losses

The saliency of these issues varies across states and types of insurance.

Prior Approval of Forms

The NAIC and many state regulators and legislatures have taken some steps to streamline and homogenize the form approval process for life insurance and annuities, including creation of an interstate compact for approval of some forms. However, the continued patchwork process by which life insurers have to obtain approval for their products under state regulation and the associated costs, delays, and refusals place life insurers at a competitive disadvantage with federally regulated competitors in the asset accumulation and management business. The form approval issue is also important for property/casualty insurers and to a lesser extent (apart from the mandated benefits issue) for health insurers. Except for states that have substantially eliminated prior approval of policy forms for "large" commercial risks, property/casualty insurance policy forms are subject to regulatory approval in all states, with associated direct costs, compliance costs, and delays. Prior regulatory approval of policy forms is unnecessary and counter-productive for commercial lines of property/casualty insurance, except perhaps for very small businesses.

Prior Approval of Rate Changes

Market structure and entry conditions are highly conducive to competition in most types of insurance. Modern insurance markets that are relatively free from regulatory constraints on prices and risk classification generally exhibit strong evidence of competitive conduct and performance. Insurers vary substantially in terms of price, underwriting, and service.

Competition creates strong incentives for insurers to forecast costs accurately and to price and underwrite so as to avoid adverse selection, thus producing highly and increasingly refined systems of rate classification. Prices vary across insurers in relation to rate classification systems and underwriting standards. Substantial evidence, including small "residual markets" in states with little or no regulatory intervention in pricing, indicates that competition in pricing and risk selection promotes the availability of coverage if rates are sufficient to cover expected costs and provide insurers with a reasonable expected profit.

Prior approval rate regulation cannot be justified as a response to monopoly or oligopoly pricing in insurance markets, nor can it be justified as necessary to prevent collusion, or to protect consumers from inadvertently purchasing coverage from high price insurers. Prior approval regulation produces significant administration and compliance costs, which are ultimately borne by consumers. The rate approval process has sometimes been contentious and biased toward rate suppression that distorts the supply of coverage.

Prior approval regulation generally cannot be expected to affect insurer profits in the long run. Insurers must expect a reasonable profit over time in order to continue to supply coverage. Even when prior approval rate regulation allows adequate rates on average, the rate filing and approval process impedes timely adjustments of rates to new information about expected costs. This regulatory lag tends to produce fewer but larger rate changes and greater swings in availability of coverage and insurer profitability. Uncertainty about approval of proposed rate changes increases insurers' risk, with possible adverse effects on insurance buyers in other states. Regulatory suppression of rates in some states during some time periods reduces voluntary market sales by current insurers, increases residual market size, reduces entry by new insurers, and reduces incentives for insurers to provide valuable services and to invest in product distribution and service.

Progress has been made among the states in reducing the scope of prior approval regulation. It is virtually certain, however, that a significant number of states, including some of the largest, will retain such policies unless motivated to change through federal action. The reasons are basically political. State legislators and regulators benefit when they claim to save consumers money. Some consumers are deeply suspicious of insurers and resent having to pay significant amounts of their income for insurance. Some consumer organizations, with ready access to major media, continue to press for rate regulation and to condemn "deregulation," claiming that "true" competition does not exist. Perhaps more important, the regulatory staffs in some states appear wedded to the mistaken notion that price controls protect consumers and serve a useful social purpose.

Classification and Issue Restrictions

Some states directly and significantly restrict insurance underwriting and rate classification for health insurance (e.g., "community rating") and/or some types of property/casualty insurance (e.g., restrictions on rate variation across geographic regions within a state). These restrictions generally lower premium rates for high-risk buyers and raise rates for low-risk buyers. In order to ensure that high-risk buyers can obtain coverage at rates that insurers recognize as lower than expected costs, insurers are required to offer coverage to virtually all applicants under “guaranteed issue” or “take-all-comers” requirements.

Guaranteed issue and rating restrictions may allow some high-risk buyers to purchase coverage who otherwise might find it difficult to locate a willing health or property/casualty insurer. But their predominant motivation and function is to lower premium rates for buyers with relatively high expected claim costs by charging above-market premium rates for buyers with relatively low expected claim costs. In the case of health insurance, in principle this might help higher-risk persons afford coverage, receive the types and quality of medical care that flow to insured persons, and cut down on both costly emergency care and bad debts for hospitals and providers. In the case of auto liability insurance, it may encourage more drivers to comply with compulsory insurance requirements, thus reducing the number of uninsured motorists and costs borne by other parties.

However, significant restrictions on rating and risk selection and guaranteed issue requirements have serious drawbacks, including:

1. Average premium rates tend to go up as more high risks insure and some low risks reduce or drop coverage.

2. Competitive rating and risk classification provide some incentive for higher-risk buyers to take actions to control losses and thus qualify for lower premiums and/or have lower uninsured losses (e.g., by forgoing construction or employing damage resistant construction in disaster prone areas, by purchasing crash-resistant vehicles, by installing security systems in homes or businesses, and so on). Restrictions on classification dull those incentives, increasing losses and premiums over time for the insured population.

3. When insurers are forced to accept applicants at regulated rates that are below expected costs for some buyers and above expected costs for others, it is very likely that the relative proportions of under- and over-priced buyers will vary across insurers. Some state reinsurance or risk-adjustment mechanism generally is needed to ensure a stable market. Such mechanisms involve significant administrative and compliance costs, and they can distort insurers' incentives for cost-effective monitoring and settlement of claims.

These problems help explain why many states have eschewed such policies. In the case of automobile insurance, the bulk of the states use residual market mechanisms (mostly assigned risk plans) to narrowly target intervention to ensure availability of coverage to the relatively few buyers who might find it hard to locate a willing insurer. On the other hand, some states have used voluntary market rate caps and residual markets as an alternative method of holding down rates for high-risk buyers in automobile or workers' compensation insurance. The result has been large residual market deficits and the need for voluntary market insureds to pay higher rates to subsidize those deficits. In the case of health insurance, over 30 states have established high risk pools to guaranty coverage to persons with chronic health conditions at subsidized rates, including all jurisdictions without any other guaranteed issue requirements. The pools generally are designed to provide subsidized coverage to a relatively narrow, high-cost segment of the public.

Mandated Benefits

A complex web of "mandated benefit" requirements, which require that if a certain type of insurance is purchased, then it must cover specified losses, characterizes the state-based system of insurance legislation and regulation. Benefit mandates are most prevalent and debated for health insurance. Many observers argue that health insurance mandates produce significant increases in the cost of health coverage in some states, and significant reductions in the number of people covered by private health insurance.

Mandates for other types of insurance in many states include requirements that homeowners and/or auto insurance policies cover tort liability claims brought by one family member for injuries caused by another; requirements that auto insurance buyers buy coverage for losses caused by uninsured motorists, including pain and suffering; and mandates (mooted by the Terrorism Risk and Insurance Act and its extension) that property insurance policies cover fire losses caused by terrorism and in some states prohibit any terrorism exclusions. Many states also significantly limit allowable deductibles and co-payments, which can significantly drive up the cost of coverage.

Many mandates are argued to serve some consumer protection function. In reality, and when they are not simply redundant (i.e., mandating what a large majority of buyers would willingly insure), mandates often simply force people or businesses to purchase and pay for insurance coverage of losses they would not willingly insure. In contrast to the cases of compulsory liability insurance laws and compulsory workers' compensation insurance laws, there would be little or no spillover on other parties without such mandates.

Optional Federal Chartering

The American Bankers Insurance Association, the American Council of Life Insurers, and the American Insurance Association agree on a number of principles for optional federal chartering to encompass life and property/casualty insurers:

1. Creation of a federal regulator to license insurers choosing a federal charter and regulate solvency, market conduct, and accounting of federally-chartered entities

2. Exemption of federally-chartered insurers from prior approval rate regulation and burdensome form approval requirements

3. Preemption of state rules to help ensure a single set of federal rules for federally-chartered insurers

4. Participation of federally-chartered insurers in the state guaranty fund system, subject to federal minimum standards
5. Repeal of the McCarran-Ferguson limited antitrust exemption for federally-chartered insurers
6. Payment of state premium taxes by federally-chartered insurers

"The National Insurance Act of 2006" (S. 2509), introduced by Senators Sununu and Johnson, incorporates most, if not all, of these principles.

Optional federal chartering along these basic lines would streamline, modernize, and homogenize regulatory requirements for federally-chartered insurers. It would almost certainly achieve efficiencies in oversight and regulation of policy forms. The results would include helping to level the playing field between insurers and federally regulated financial institutions. Very importantly, federally-chartered insurers would be substantially freed from antiquated and counter-productive prior approval rate regulation.

Participation in State Residual Markets and Guaranty Funds

If federally-chartered property/casualty insurers could be exempted from participation in state residual markets, residual market rate regulation could not be used to produce sustainable cross-subsidies among insurance buyers. States that wanted to cap rates for higher-risk buyers would have to finance rate subsidies some other way. Exemption, however, seems unlikely in view of legitimate state interests in ensuring the availability of mandatory coverages. In order to reduce the ability of states to use residual markets to cap property/casualty insurance rates (e.g., in automobile and workers' compensation insurance), the best approach (incorporated in S. 2509) is probably to make participation of federally-chartered insurers in property/casualty residual markets contingent on rates being set at self-sustaining levels. To be sure, disputes as to whether that type of criterion is being met in some states are likely inevitable.

A federal guaranty system for federally-chartered insurers would destabilize and eventually completely crowd out the state system. Requiring federally-chartered insurers to participate in the state guaranty fund system, perhaps subject to some minimum standards, is sensible. S. 2509 would require federally-chartered insurers to participate in "qualified" state guaranty associations and establish a national guaranty fund, with ex post assessments, for obligations of insurers doing business in any non-qualified states.

The guaranty system under federal chartering, however, would likely evolve towards nationalization or quasi-nationalization with uniform coverage. Insolvency of a multistate federally-chartered insurer with different coverage limits in different states would very likely create strong pressure for uniform, national coverage. Insolvency of a number of state chartered-insurers would likely create similar pressure. Such an evolution very likely would be accompanied by some federal oversight of the insolvency risk of state-chartered insurers (as is true for state-chartered banks with federal deposit insurance).

As I have emphasized in a number of my publications, any move towards optional federal chartering involves a risk that the scope of government guarantees of insurers' obligations will ultimately increase, thus increasing moral hazard and producing pressure for stricter solvency standards. A fundamental goal of the guaranty system with optional federal chartering should be to maintain reasonable coverage limits overall and to include significant restrictions on coverage for commercial insurance, at least for buyers with substantial net worth. The creation of a pre-funded, federal system for all insurers should be avoided. It is highly unlikely that meaningfully risk-based charges for guaranty fund coverage would accompany pre-funding, and pre-funding could dull some insurers' incentives to press for effective solvency regulation and standards.

Regulatory Competition

Optional federal chartering would presumably provide additional and immediate motivation for state regulators to modernize their systems. More generally, it could promote beneficial regulatory competition over time if insurers are able to switch charters and regulators at relatively low cost. Dual chartering of banks appears to have resulted in a certain degree of beneficial regulatory competition. However, the cost to multistate, federally-chartered insurers to switch back to a state charter and return to state regulation in multiple states might be larger than in banking. If so, there is a greater risk that federal chartering could become dominant and entrenched for larger, multistate insurers, reducing the scope of regulatory competition.

Substantial Elimination of Rate Regulation

The substantial elimination of prior approval rate regulation should be the *sine qua non* for optional federal chartering of property/casualty insurers. Elimination of prior approval rate regulation for federally-chartered property/casualty insurers would be very likely to constrain substantially prior approval of rates for state-chartered insurers as well. Again, however, there are inherent uncertainties, including the scope of federally-chartered insurers' exemption from rate regulation that will be included in any bill that might be passed, and regarding whether any exemptions will persist. It is also uncertain whether federal regulation would persistently resist temptation to redistribute wealth through restrictions on rate classification, guaranteed issue, and mandates. State regulation is largely unable to achieve cross-subsidies between states (or between lines of business within a state). While federal regulators may be more resistant to local pressures that produce within-state cross subsidies, they may face similar pressures on a national level and significant pressure over time for adopting or endorsing policies that promote cross-subsidies within and between states.

Other Approaches to Spurring Regulatory Modernization

The case for insurance regulatory modernization through increased uniformity and substantial deregulation of rates and forms is overwhelming. Optional federal chartering might go a long way towards achieving this result. But there are risks, and it would require substantial investment and costs in creating and maintaining a federal regulatory agency. Potential unintended consequences, or mistaken policies in response to political pressure, would have national effects. Two alternatives to improve insurance regulation without creating a federal regulator and which might entail less risk are: (1) federal preemption of state regulations that do not meet minimum standards, and (2) allowing insurers to choose a state for primary regulation with authorization to operate nationwide primarily under the rules of that state.

Minimum Standards and Preemption

The enactment of minimum federal standards for and preemption of certain forms of regulation could help modernize insurance regulation without creating a true federal regulator and associated bureaucracy. The potential effectiveness of this approach as a means to remedy the key problems of rate and form regulation is not clear. Prohibiting prior approval rate regulation, for example, by itself would not prevent regulators in some states from challenging rates based on allegations that they are excessive or unfairly discriminatory. The threat of such actions could contribute to a de facto prior approval environment. More generally, any “minimum standards” approach faces the difficulty of monitoring compliance. States that did not wish to comply would attempt to circumvent or evade the requirements.

A draft proposal, The State Modernization and Regulatory Transparency Act (SMART), released by Representatives Oxley and Baker, would establish minimum and uniform federal standards for numerous activities of state regulation, with federal preemption of state laws and rules failing to meet such standards after specified periods. The complex proposal deals with regulation of insurer and producer licensing, market conduct, policy forms, rates, surplus lines, reinsurance, fraud, solvency oversight, receivership of insolvent insurers, and the viatical market. A “State-National Insurance Coordination Partnership” would be created to oversee rules, changes, and compliance.

The proposal contains provisions designed to promote uniformity and provide for one-stop approval of policy forms, and to eliminate prior approval rate regulation for commercial property/casualty insurance (excepting medical malpractice insurance). The proposal’s breadth and complexity increases the difficulty of enforcement and the likelihood of unintended consequences. A narrower and simpler standards / preemption approach would focus on policy forms, rates, and possibly mandates.

Primary State Regulation

Another approach to spurring modernization without federal regulation would be for the Congress to enact legislation that would allow insurers to choose a “primary state” for the purpose of rate, form, and possibly a number of other types of regulation and allow them to operate in all other states where they are licensed (“secondary states”) without having to meet the corresponding requirements in those states. The general concept has its roots in corporate law, where corporations choose a state in which to be chartered, with that state's laws governing the rights of management and shareholders throughout the country. The concept is to some extent reflected in federal authorization of risk retention groups for certain types of property/casualty insurance.

The Health Care Choice Act, proposed by Representative Shadegg and Senator DeMint, adopts this approach for individual health insurance. Insurers would be subject primarily to regulation by the primary state, but they could operate in secondary states subject to primary state rules. The proposal includes a number of safeguards and minimum standards for primary state regulation regarding, for example, solvency regulation, guaranteed renewability of contracts, and independent review of disputed claims. The bill requires clear disclosure and warning to consumers that primary state regulation applies and that various secondary state regulations do not. The main purpose is to allow consumers in states with mandated benefits, guaranteed issue, and/or community rating rules that drive up the cost of individual health insurance coverage to have the opportunity to buy coverage not subject to those constraints. Many consumers would likely be able to obtain less costly coverage that is more closely related to their needs and ability to pay.

More generally, the primary regulator approach could be an effective means of achieving substantial homogenization and streamlining of policy form regulation for all types of insurance – and of significantly constraining prior approval rate regulation – with relatively little federal involvement. A common argument against this general approach is that it could lead to a "race to the bottom." That risk is reduced significantly by would-be primary states' concerns with their own citizens' welfare and by buyers (and agents/brokers) concerns with their own welfare. I believe that this risk could be managed with well-designed minimum standards and clear disclosure. It also, for example, would not be necessary to rely mainly on the primary state for solvency oversight and/or market conduct regulation.

Conclusion

Despite the existence of economically appropriate regulatory regimes in many states, certain aspects of state regulation – in particular the regulation of rates, rate classification, and policy forms in many states – appear beyond repair at the state level. Some form of federal intervention is necessary for fundamental change.

The central goals of regulatory modernization should be to provide one-stop approval or certification of policy forms, to have virtually all rates, rate classes, and covered benefits determined by competition rather than regulation, and to preserve and enhance private market incentives for safe and sound insurance. The key policy question is what form of federal intervention has the best potential for achieving these goals given short- and long-run political dynamics and the risks of unintended consequences.

Optional federal chartering and regulation of insurers offers the potential to achieve more streamlined, less duplicative, and pro-competitive regulation. A well-designed optional federal chartering system would have a number of potential advantages. It would also entail the creation of a new federal bureaucracy and inherent risks. The alternative of allowing insurers to designate a "primary state" and to operate nationwide subject in large part to the regulations of that state might have the potential to improve significantly the performance of insurance regulation with relative simplicity, less risk, and without creating a federal regulator. A narrowly targeted program of minimum federal standards that would preempt non-conforming state regulation also has the potential to improve insurance regulation without creating a federal regulator, and perhaps also with less risk than federal chartering.