Insurance Regulation

- The rules of the marketplace, established by law, administered by public officials, and interpreted by the courts
- Purpose is to promote and protect the public’s welfare because of the special qualities of the insurance marketplace
- McCarran Act (Public Law 15) - Federal law that gives the power to the states to regulate insurance

Reasons for Insurance Regulation

- Insurer solvency issues
- Unequal knowledge and bargaining power
- Problem of pricing
- Promotion of social goals
Insurer Solvency
- Insurance is a promise to be delivered in the future – consumers find it difficult to evaluate and monitor insurer solvency to protect oneself
- Insolvent insurers:
  - Cause serious problems for insureds due to the scope and number of people involved - severity potentially enormous
- Companies are in a quasi-fiduciary position
  - Life insurance companies invest a substantial amount of savings
  - Accounting (statutory accounting) and investments highly regulated

Unequal Knowledge and Bargaining Power
- Imbalance in competition of marketplace
  - Complexity of contracts; difficult to understand
  - Insurance is an intangible good
- Difficult for consumer to evaluate so a public regulator is needed
  - To provide “standardized” approved contracts
  - To equalize consumer’s bargaining power

Problem of Pricing
- Open competition pricing said not to work because prices are set before costs are known - sometimes years
- Consumers cannot judge the adequacy of prices
  - Solvency regulation substituted for unrestrained competition to generate sales of the most contracts at a below cost price.
Types of Price Regulation
- Prior approval
- File and use
- Open competition

Promotion of Social Goals
- Promotes the sharing of losses for society
- Increase availability of product
  - Assigned risk plans, joint underwriting associations; Forces insurers to accept exposures - causes subsidization
- Directing investments to certain areas - regulates what insurers can invest in
- Promotes domestic vs. foreign or alien insurers - retaliatory laws

History of Insurance Regulation
- States currently regulate insurance
- Paul vs. Virginia (1869)
  - Paul - agent in New York solicited business in Virginia without a Virginia license
  - Paul argued he did not need a license since this was interstate commerce
  - Virginia stated Paul was a citizen doing business in Virginia and subject to Virginia law
  - Supreme Court agreed with Virginia that insurance was NOT interstate commerce - so insurance is under state regulation
History of Insurance Regulation

- 1905 Armstrong Committee investigated life insurance
- 1910 Merritt Committee investigated fire insurance
- Both found undesirable characteristics and practices
- Outcome was a strong New York Insurance Code regulating the business

History of Insurance Regulation

- U.S. vs. Southeastern Underwriters Association (SEUA) (1944)
  - Reversed Paul vs. Virginia: Supreme Court said insurance was interstate commerce
  - SEUA had a virtual monopoly on the insurance business in southeastern U.S.
  - SEUA was an association for rate making purposes and violated federal anti-trust laws but federal law did not apply so Paul had to be overturned to break up the SEUA
  - There was no existing federal regulation and there was strong opposition to federal regulation after this decision

History of Insurance Regulation

- The McCarran Act passed in 1945
  - Public Law 15
  - Federal law to allow states to regulate as long as they do a “good job”
  - By 1950 every state passed regulation
  - McCarran Act exempts insurance from most anti-trust regulation
Current Status of Insurance Regulation

- States regulate and each state has its own insurance code
- New York has the Appleton Rule - Any company doing business in NY must meet NY standards anywhere they do business
- National Association of Insurance Commissioners (NAIC)
  - Promotes consistency
  - Model bills and legislation
  - Research special problems

Gramm-Leach-Bliley Act of 1999

- Purpose: To modernize the US financial services markets, formalize regulation, and make markets more competitive.
- Allows financial institutions to form holding companies of banks, insurance and investment firms
- Regulation will remain based on historic pattern
- Federal Reserve and Treasury will continue to regulate banks
- SEC will continue to regulate security dealers
- State insurance commissioners will continue to regulate insurance activities.
- Meet consumer needs
  - Economies of scale – lower cost
  - Economies of scope – more efficient with other forms of financial transactions

GLB - Banks

- Desired the passage of GLB seeing the potential for national and global operations, economies of scale and scope
- Rapid change in communication technology makes this possible
  - Computer and communication technology facilitates the transactions by firms 24 hours a day and 7 days a week
- International / Global competition
  - Since banks in the EU (European Union) combined many financial service activities before GLB the incentive existed to pass GLB to put US firms on equal footing.
Federal vs. State Regulation

Arguments for State Regulation
- State regulation is a known quantity; their job is done reasonably well
- If Federal law passed there would still be a need for state regulation
- Allows for experimentation
- Closer to the public and its problems

Arguments for Federal Regulation
- There would be substantial improvement in efficiency and uniformity in regulation - companies would only have to comply with one set of rules
- If a company wants to leave because of obnoxious laws it could not withdraw from federal regulation - still have to play the game by the rules
- States do not have expertly trained personnel and adequate budgets - Federal regulators would be better staffed
- Federal regulators less subject to company pressure
- Federal Government could more easily handle insolvencies
- Federal already regulates due to GLB '99
- Less barriers to foreign companies entering US market

Problems of uniformity and efficiency
- State Insurance Compacts (passed in many states) provides cooperation among states for life insurance products
Regulated Activities by the States

- Investment Activities
  - Life different from Non-life;
  - Risk of the investments.
  - Valuation is conservative
- Legal Reserves and Surplus
  - Reserves - a legal liability
  - Surplus - cushion for bad underwriting, expense, or investment results
  - Minimum of capital and surplus to start
  - Risk Based Capital (RBC) requirements

Regulated Activities by the States

- Guarantee funds
  - In all states
  - Designed to protect policy owners from insolvent insurance companies
- Rate Regulation
  - Rates are to be adequate, fair, and not unfairly discriminatory
  - File and use, open rating, prior approval systems

Regulated Activities by the States

- Accounting Procedures
  - Expenses not deferred - surplus underestimated
  - Only admitted assets allowed - conservative estimate of assets
  - Unearned premium reserve
  - Loss reserves
  - Policy reserves - life insurance
- Policy Form, Approval, and Expense Limitations
  - Form must be approved by the states
  - Rates (prices) are regulated
  - Commissions can be limited
Activities Regulated By The States

- Licensing Companies, Agents and Brokers
  - Company must be licensed in state
  - Agent/ Broker must be licensed
  - When insurance in state not available can go to non-admitted insurer through excess and surplus lines agent

- Consumer Complaints
  - State complaint hot lines
  - Complaint ratios are kept
  - States can terminate license of company

Regulated Activities

- State premium taxation, similar to sales tax but on insurance contracts
- Complex formulas for Federal Income Taxation

**FIGURE 10-1** Life Insurance Reserves

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\text{Legal Reserve} = \text{Present Value of Future Death Claims} - \text{Present Value of Future Net Premiums}
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