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Revising Insurance Regulation: Policy Considerations

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Baird Webel
Analyst in Economics
Government and Finance Division

Carolyn Cobb
Insurance Consultant
Government and Finance Division

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Summary

All insurers are now regulated by the 50 states. Since the 107th Congress, committees in both houses of Congress have considered whether that framework of insurance regulation meets the demands of the marketplace and the needs of businesses and individuals.

A key issue is the relative merit of federal regulation of the insurance industry compared to the current state-based regulation. Less emphasized but also significant are the differences that arguably exist among kinds of insurance, for the industry is hardly monolithic. There are also fundamental policy issues concerning why and how each kind of insurance might be regulated, and about what national interests may be involved in resolving these questions.

This report discusses federal regulation of insurers — whether optional or mandatory — in that broader context. To assist that discussion, it traces the evolving rationale for regulation generally, explains insurers' roles as risk managers and financial intermediaries, and reviews briefly important aspects of the major lines of insurance.

Many economists and scholars now generally agree that competitive markets can allocate resources — including capital — more effectively than regulation. Empirical studies have cast some doubt on a common rationale for insurance regulation (i.e., that insurance is a public utility and that regulators can achieve socially optimal pricing and socially desirable pricing). Studies have also shown that the insurance market is competitive; courts have so narrowed its antitrust exemption that it functions competitively.

Managing risk of financial loss is fundamental to the U.S. economy. Insurance is one way to manage risk; for businesses, there are economic substitutes for insurance. Insurers serve the U.S. economy as financial intermediaries, like banks, and their investment portfolios are significant.

Different kinds of insurance can be classified in several ways. One option, when considering why or how to regulate, is to classify by whether the purchaser is a business or an individual. Businesses may not need the same level of regulatory protection that individuals might.

This report will be updated in the event of major legislative activity.

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Revising Insurance Regulation: Policy Considerations

Introduction

The power to regulate insurance currently rests primarily with the individual states. This primacy, however, has been slowly decreasing over time. Congress has become increasingly involved in regulating insurance and in overseeing states' regulation of insurance, and the corporate National Association of Insurance Commissioners (NAIC) has assumed a national role.¹ Insurers and state insurance regulators are now discussing whether to modify the current federalism balance and if so, how. Resolving the question — intellectually or politically — involves reviewing the risk management market generally and the insurance market specifically, deciding on purposes for regulating, and crafting a federalism framework that can accomplish those goals.

The Debate Over Optional Federal Regulation

Insurance is one way to finance risk of loss. Large U.S. insurers — both life and property-casualty — are competing with other providers of risk-financing, nationally and internationally, such as banks and the capital markets. They believe that they have less efficient regulation than those cross-sectoral competitors. In their view, that imposes adverse macroeconomic and microeconomic consequences² because it steers capital away from insurers. They believe that having a single federal regulator might provide more efficient regulation, which would enhance their competitive position, attract capital, and reduce macroeconomic distortions.

State insurance regulators, smaller insurers, and consumer groups have a different view of insurance. State insurance regulators view their purpose as consumer protection, not macroeconomic or microeconomic capital allocations. Smaller insurers do not view themselves as competing for capital with other types of

¹ CRS Report RL31982, *Insurance Regulation: History, Background, and Recent Congressional Oversight*, by Baird Webel and Carolyn Cobb traces the development of the current balance of power between the national and state governments with respect to insurance regulation.

² Macroeconomics studies aggregate markets, and microeconomics studies individual economic units — such as investors, businesses, and consumers. These distinctions can be arbitrary, as aggregate markets are the collective decisions of individual economic units in that market. Robert S. Pindyck and Daniel L. Rubinfeld, *Microeconomics* (Macmillan, New York: 1989), pp. 3-5.

financial intermediaries. Consumer representatives view insurance as vested with a public interest that market competition is ill equipped to meet. Collectively, these interests believe that current state insurance regulation provides the best form of consumer protection and that, though states' regulation is not uniform, it can be made efficient enough to serve the public interest.³

The debate gets into the purpose or purposes of insurance regulation. Some might argue, for example, that insurers should be regulated to assure availability and affordability of insurance for consumers and businesses. Others might argue that insurers should be regulated to assure a competitive market in financial services — an argument that presupposes consensus on what “the market” is.⁴ These arguments — though heated within the insurance industry and between it and its state regulators — generally do not incorporate broader public policy issues.

This report examines what regulation, if any, would be appropriate in subsets of a private sector that is competitive and not monolithic. What might be the goal of regulation of each basic kind of insurance? Why regulate each line at all? Should commercial policies, for example, be regulated just like individual consumers' auto policies? If so, why? If not, why not? What is the cost of regulation — for businesses? For consumers? Should life insurers be regulated like property-casualty insurers? Should reinsurers be regulated? Why regulate the market at all? What is “the market?”

Why Regulate?

Conventional Theories

Early theories about why government does or should regulate insurance companies persist, even though many scholars and economists no longer find them useful. One persistent perception has been that the insurance industry has captured its regulators, and that state-level regulation therefore benefits insurers rather than consumers.⁵ Empirical study has cast serious doubt on that theory, however, finding that capture does not occur because the insurance industry is too diverse.⁶

³ For an overview of this viewpoint, see U.S. Congress, Senate Committee on Commerce, Science and Transportation, *Federal Involvement in Regulation of the Insurance Industry*, hearing statement of the Independent Insurance Agents and Brokers of America by Mr. Tom Ahart, 108th Cong., 1st sess., Oct. 22, 2003, available at [<http://commerce.senate.gov/pdf/ahart102203.doc>].

⁴ CRS Report RL30516, *Mergers and Consolidation Between Banking and Financial Services Firms: Trends and Prospects*, by William D. Jackson. This report provides an overview of the participants' view of the marketplace.

⁵ The theory of regulatory capture originated in George J. Stigler, “The Theory of Economic Regulation,” *Bell Journal of Economics and Management Science*, vol. 2, spring 1971, pp. 3-21.

⁶ Kenneth J. Meier, *The Political Economy of Regulation: The Case of Insurance* (Albany: (continued...))

Another theory has been that insurance resembles a public utility, that is, insurers provided such a basic service to the public (like airlines or telephone companies) and that it should be regulated by the government in the best interest of consumers. Proponents thought regulators should — and could — achieve socially optimal pricing and socially desirable access.⁷ Experience disproved that theory also, and regulatory reform began — and continues — in many sectors of the U.S. economy.⁸

A third persistent but controversial view is that insurers have a complete exemption from antitrust laws and so must be regulated to control anti-competitive behavior. Regulation and later the insurance exemption in the McCarran-Ferguson Act⁹ did keep some insurance rates artificially high.¹⁰ As courts have increasingly narrowed the exemption over the last 50 years,¹¹ however, competition has increased.¹² McCarran-Ferguson is now understood to allow insurers to share only historical information about the timing and scope of their losses, which actually promotes competition, since it gives new market entrants access to that historical information.¹³

⁶ (...continued)

State University of New York Press, 1988).

⁷ See Richard E. Stewart, “The Social Responsibility of Insurance Regulation,” in *Insurance and Insurance Regulation: Speeches and Papers 1968-1992*, pp. 1-5, available at [<http://www.stewarteconomics.com/Book020500.PDF>], pp. 4-8. In 1968, at the time Mr. Stewart gave this speech, he was Superintendent of Insurance in New York and president of the National Association of Insurance Commissioners.

⁸ See Clifford Winston, “Economic Deregulation: Days of Reckoning for Microeconomists,” *Journal of Economic Literature*, vol. 31, Sept. 1993, pp. 1263-1289. See also Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions* (Cambridge MA: MIT Press, 1998), pp. xv-xxxvii.

⁹ 15 U.S.C. §1012(b).

¹⁰ Chao-chun Leng, Michael R. Powers, and Emilio C. Venezian, “Did Regulation Change Competitiveness in Property-Liability Insurance? Evidence from Underwriting Profit and Investment Income,” in *Journal of Insurance Regulation*, vol. 21, winter 2002, pp.57-78. See also Scott E. Harrington, “Insurance Rate Regulation in the 20th Century,” in *Journal of Insurance Regulation*, vol.19, winter 2000, pp. 204-218.

¹¹ See CRS Report RL31982, *Insurance Regulation: History and Background*, by Baird Webel and Carolyn Cobb.

¹² See Tim Wagner, “Insurance Rating Bureaus,” in *Journal of Insurance Regulation*, vol. 19, winter 2000, pp. 189-203. See also U.S. Congress, House Committee on Financial Services Committee, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, *The Effectiveness of State Regulation: Why Some Consumers Can’t Get Insurance*, House Committee on Financial Services, hearing, 108th Cong., 1st sess., Apr. 10, 2003.

¹³ Wagner, “Insurance Rating Bureaus,” p. 201; Meir Kohn, *Financial Institutions and Markets* (New York: McGraw-Hill, 1994), p. 401.

Current Theory of Regulation

Experience and research generally support the current theory that competitive markets can allocate resources more effectively than regulation,¹⁴ although consumer representatives often disagree.¹⁵ On the other hand, economists generally recognize that markets are not always perfectly competitive, and that they can fail to capture the full benefits or costs of some activities or inactions. That is why some economists suggest that government intervene in private markets only to

- prevent systemic risk;
- promote market efficiency; or
- accomplish a social policy.¹⁶

Systemic risk is the risk that a single institution's default will trigger a chain reaction of defaults, leading to loss of confidence that undermines an entire financial system.¹⁷ The term has generally been used in the banking context, referring to concerns about consolidations creating more banks "too big to fail."

Promoting market efficiencies is another rationale for government intervention, since insurance markets — like other markets — can be imperfectly competitive. Parties to an insurance contract might have less than complete information about each other, for example; economists call that potential "informational asymmetry." U.S. securities laws have addressed informational asymmetry by requiring prospectuses, for example; insurance regulators have required insurers to submit their contracts, and often their rates, for prior approval. The U.S. antitrust laws — to which the insurance industry is subject — are another example of government intervention to promote market efficiency.

Accomplishing a social policy is a third rationale for government intervention. Congress has, for example, created the flood insurance program¹⁸ and the terrorism backstop.¹⁹ State legislatures have mandated certain health insurance coverages and created pools for those unable to obtain insurance in the private market. These are examples of intervention with a social or public policy purpose; it is analytically

¹⁴ Kohn, *Financial Institutions and Markets*, pp. 398-400. See also, e.g., Scott E. Harrington, *Insurance Deregulation and the Public Interest* (Washington : AEI-Brookings Joint Center for Regulatory Studies, 2000), at [<http://aei-brookings.org/admin/pdffiles/harrington.pdf>].

¹⁵ See U.S. Congress, Senate Committee on Commerce, Science and Transportation, Federal Involvement in Regulation of the Insurance Industry, hearing statement of the Consumer Federation of America by Mr. J. Robert Hunter, 108th Cong., 1st sess., Oct. 22, 2003, available at [<http://commerce.senate.gov/pdf/hunter102203.doc>].

¹⁶ Kohn, *Financial Institutions and Markets*, pp. 398-400.

¹⁷ See Eugene Ludwig, "Systemic Risk: A Regulator's Perspective," *Fannie Mae Papers*, vol. 1, no. 1, Feb. 2003, p. 1, at [<http://www.fanniemae.com/commentary/pdf/fmpv2i1.pdf>].

¹⁸ 42 U.S.C. §4001 et seq.

¹⁹ P.L. 107-297, 116 Stat. 2322; see CRS Report RS21444, *The Terrorism Risk Insurance Act of 2002*, by Baird Webel.

useful to consider them for purposes of this report as social choices rather than as market failures.

Insurers' Role In Society?

Insurers Are Subset of Risk Management Marketplace

Managing risk is fundamental to our economy and our society. Individuals and businesses have choices about how to manage risks, depending on whether they perceive any uncertainty and on how risk-averse they are. They can mitigate by controlling the risk — as in wearing seatbelts or hard-hats — and they can finance them — as in setting aside reserve funds for contingencies (“self-insuring”) or buying insurance. Any risk of financial loss can be financed if the financing entity has enough reliable, objective information about the probability of that loss.²⁰

Risk of financial loss can be financed by retaining it, which means that individuals or businesses can self-insure. Corporations, for example, form their own downstream, or “captive,” insurers.²¹ Risks can also be financed by transferring them, which means exchanging an uncertain future financial exposure for a stated current fee. Individuals, for example, can buy insurance. Corporations can buy insurance or options or hedges to shift risk. Risks can also be financed by sharing them. Individuals share risks through insurers as intermediaries. Corporations can buy insurance, too, but they can also — or instead — buy or sell a derivative.²²

There are economic substitutes, in other words, for insurance. This is particularly true for entities with access to the capital markets. Insurers are competing with the suppliers of those substitutes. Insurers' competition includes banks, securities firms, and capital markets — inside the United States and internationally. Presently, these economic substitutes are disparately regulated, so that similar risks are subjected to different capital requirements in different financial

²⁰ C. Arthur Williams, Jr., Michael L. Smith, and Peter C. Young, *Risk Management and Insurance* (New York: McGraw-Hill, 1995), pp. 196-237.

²¹ See Elizabeth R. Costle and Kathleen A. Schauer, “The Captive Alternative: A Regulatory Perspective,” *Journal of Insurance Regulation*, vol. 19, winter 2000, pp. 304-323. The authors define a captive as a closely held insurance company owned by one or more organizations to insure some or all of the risks of shareholders or affiliated organizations. Captives are subject to substantially less regulation than other insurers. *Ibid.*

²² Emmett J. Vaughan and Therese M. Vaughan, *Fundamentals of Risk and Insurance* (New York: John Wiley & Sons, 1996), pp. 9-12. A derivative is formally defined as “a zero net supply, bilateral contract that derives most of its value from some underlying asset, reference rate, or index.” Christopher L. Culp, *The ART of Risk Management: Alternative Risk Transfer, Capital Structure, and the Convergence of Insurance and Capital Markets* (New York: John Wiley & Sons, 2002), p. 264. See also CRS Report RL31045, *Financial Risk: An Overview of Market and Policy Considerations*, by Mark Jickling.

sectors, even inside the United States.²³ Entities with access to less capital intensive risk financing mechanisms will choose them;²⁴ individuals may not have access to those choices.

Insurers' share of the commercial risk-transfer marketplace has been diminishing. Experts expect that by the end of 2003 about half of all U.S. commercial market risks will be transferred out of the conventional regulated insurers, up from a third in 1996.²⁵ The global premium for alternative risk transfer is estimated at \$88 billion in 2001, compared to \$370 billion in commercial premium paid to traditional insurers.²⁶ The trend is expected to escalate as traditional insurers' capital remains tight and their capacity small and as corporations create captives to cover their employee benefits.²⁷ The number of U.S. risk retention groups and purchasing groups is rising rapidly.²⁸

Insurers Are Financial Intermediaries

Insurers serve as financial intermediaries, accumulating savings (premiums) and investing them in order to pay future claims. They compete for those savings and investments with other financial intermediaries, such as banks, mutual funds, and the capital markets. Life insurers issuing annuities and underwriting pension funds invest for a longer horizon than do property-casualty insurers, holding primarily corporate bonds and mortgages. Property-casualty insurers, in contrast, do not hold large portfolios of mortgages or real estate, holding instead more liquid government and special revenue bonds as well as some common stock.²⁹

Insurers' investment portfolios are significant in the U.S. economy. Life insurers in 2003 held \$3.80 trillion in assets, of which \$1.01 trillion was in corporate

²³ The Joint Forum, *Risk Management Practices and Regulatory Capital: Cross-Sectoral Comparison* (Basel, Switzerland: Bank for International Settlements, 2001), available at [<http://www.bis.org/publ/joint04.htm>].

²⁴ Some of these alternate risk-financing methods use captives and risk-retention groups. Others use finite risk reinsurance, securitizations, or structured finance contracts. See Swiss Re, Sigma 1-2003, *The Picture of ART* (Swiss Re: Dec. 9, 2002), available at [[http://www.swissre.com/INTERNET/pwofilpr.nsf/vwFilebyIDKEYLu/SHOR-5J3KEN/\\$FILE/sigma1_2003_e.pdf](http://www.swissre.com/INTERNET/pwofilpr.nsf/vwFilebyIDKEYLu/SHOR-5J3KEN/$FILE/sigma1_2003_e.pdf)].

²⁵ Insurance Information Institute, "Captives and Other Risk-Financing Options," June 2003, available at [<http://www.iii.org/media/hottopics/insurance/test3/>].

²⁶ Swiss Re, *supra* note 23, p. 4.

²⁷ See David Pilla, "Maximum Exposure: Rocked by the combination punch of corporate accounting scandals and the bear market following the major hit from Sept. 11, reinsurers face a new world of being scrutinized by trading partners while scrambling for capital," *Best's Review*, August 2003, pp. 38-46; Joel S. Chansky and Charles M. Waldron, "Employee Benefits in Captives - \$50 Million of Savings?," available at [http://www.milliman.com/pc/publications/captives/dol_article_f.pdf]; David Pilla, "Employee Benefits: The Next Big Captive Market?," *BestWire*, Aug. 9, 2001.

²⁸ See statistics from *The Risk Retention Reporter*, available at [<http://www.rrr.com/>].

²⁹ Vaughan and Vaughan, *Fundamentals of Risk and Insurance*, pp. 35-36.

equities and \$2.12 trillion in corporate and government bonds.³⁰ Property-casualty insurers — because they write short-term insurance — have smaller investment portfolios. In 2003, they held \$1.05 trillion in assets, of which \$182 billion was in corporate equities and \$621.9 billion in corporate and government bonds.³¹ The aggregate insurance sector in 2003 held 11% of the total assets held in the financial services sector.³²

Insurers, particularly life insurers, are also significant net lenders in U.S. credit markets. In 2002, they lent 9.1% of the total available in the U.S. credit market; by comparison, U.S.-chartered commercial banks lent 16.9% of the total. In 2002, property-casualty insurers lent about 1.5% of the total funds available.³³

A significant portion of U.S. insurers and the U.S. insurance market are now foreign-controlled. In 2003, for example, \$745 billion or 19% of U.S. life insurers' assets were foreign-controlled and 120 U.S. life insurers were foreign-owned, up from 69 in 1995. The proportion of foreign ownership has grown from 4% in 1995 to 11% in 2003, though it is actually down from 12% in 2001.³⁴ Among the world's 10 largest life insurance companies in 2003, only the ninth largest was domiciled in the U.S.³⁵ In 2002, at least 16% of U.S. property-casualty insurers' assets were foreign-controlled.³⁶ From 1992 to 2000, "sales of property/casualty insurance by foreign-owned companies doing business in the United States grew 64.0 percent."³⁷

³⁰ American Council of Life Insurers (ACLI), *Life Insurers Fact Book 2004*, p. 17, see [<http://www.acli.com/ACLI/About+ACLI+nonmember/Industry+Facts/2004+Life+Insurers+Fact+Book.htm>].

³¹ Insurance Information Institute and the Financial Services Roundtable, *The Financial Services Fact Book 2005* (New York: Insurance Information Institute, 2005), available at [<http://www.financialservicesfacts.org/financial2/insurance/pcfinancial/>].

³² *Ibid*, see [<http://www.financialservicesfacts.org/financial2/today/assets>].

³³ Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States: Annual Flows and Outstandings, 1995-2002* (Washington: Board of Governors of the Federal Reserve System, 2003), available at [<http://www.federalreserve.gov/Releases/z1/current/annuals/a1995-2002.pdf>], p. 1, entitled "Total Net Borrowing and Lending in Credit Markets." This flow-of-funds excludes corporate equities and mutual fund shares.

³⁴ *Life Insurers Fact Book 2004*, pp. 30 and 6.

³⁵ International Insurance Institute, "World's Largest Life Insurance Companies (2003)," *International Facts*, at [<http://www.internationalinsurance.org/international/rankings/>].

³⁶ Davin D. Cermak, Economist, National Association of Insurance Commissioners, Kansas City, MO, electronic mail to author, June 26, 2003. This estimate is based on information that insurers file with the National Association of Insurance Commissioners (NAIC); it likely underestimates the percentage that is foreign-controlled, since insurers with less than 10% foreign ownership need not report it.

³⁷ Insurance Information Institute, *The Fact Book 2004* (New York: Insurance Information Institute, 2004), p. 6.

Four U.S. insurers are among the world's 10 largest property-casualty insurers by 2003 revenue.³⁸

Kinds of Insurance

Direct Insurance

Insurance covering mortality and morbidity risks is known collectively as “life insurance.” Insurance covering property and liability risks is known collectively as “property-casualty insurance.” Health insurance may be classified as either, depending on the type of insurer issuing the contract. The term “direct insurance” means any and all insurance coverages that persons or businesses purchase from insurers. It excludes “reinsurance,” which refers to insurance purchased by insurers.

Property-Casualty Lines. The property-casualty insurance industry earned a 4.4% return on equity in 2002 — while risk-free 10-year U.S. Treasuries earned a 4.6% return.³⁹ The property-casualty insurance sector underperformed the Fortune 500 by 5.3% on average from 1988 through 2002.⁴⁰ That record impairs insurers’ ability to attract and retain capital, which shrinks its capacity to finance risk. That, in turn, makes insurance less available and less affordable — while other forms of risk financing become more attractive to purchasers with alternatives.⁴¹

Property-casualty insurance can finance a risk that one’s property will be destroyed by disaster or accident, a risk that one will be sued, or a risk that someone else will fail to perform as they promised. These coverages are called, respectively, property insurance, liability insurance, and surety insurance. They are “personal lines” coverages if they are purchased to mitigate risk at home or in the family, and “commercial lines” if purchased to mitigate risk in a trade or business.

Personal Lines. The National Association of Insurance Commissioners has estimated that the average family “can easily spend” about \$4,500 annually on insurance.⁴² In the aggregate, about half of the net property-casualty insurance

³⁸ Ibid., p. 2; also at [<http://www.internationalinsurance.org/international/rankings/>].

³⁹ Testimony of Senior Vice President and Chief Economist Robert P. Hartwig, Insurance Information Institute, in U.S. Congress, House Financial Services Committee, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, *The Effectiveness of State Regulation: Why Some Consumers Can’t Get Insurance*, hearing, 108th Cong., 1st sess., Apr. 10, 2003, Serial No. 108-22 (Washington: GPO, 2003), p. 1, available at [<http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=205>].

⁴⁰ Ibid.

⁴¹ Ibid. See also Scott E. Harrington, *Insurance Deregulation and the Public Interest* (Washington: AEI Press, 2000).

⁴² U.S. Congress, House Committee on Financial Service, Subcommittee on Capital Markets, Insurance and Government sponsored Enterprises, Insurance Regulation and Competition for the 21st Century, testimony of the National Association of Insurance (continued...)

premiums written in the United States in 2003 were spent on homeowners' multiple peril and private passenger auto,⁴³ which are the major personal lines. In most cases, these coverages are mandatory — that is, lenders require homeowners' insurance as a precondition to a mortgage, and states require automobiles to be insured as a precondition of driving.

Historically, states regulated both the terms and price of both homeowners and automobile insurance.⁴⁴ The purpose was to protect the consumer, in several ways. Contract terms were subject to prior approval and regulation because the consumer, it was thought, had no bargaining power. Prices were regulated to keep insurers from charging too little — thereby risking insolvency — or too much — thereby obtaining excessive profits because the coverage was compulsory.⁴⁵

More recent theory and experience have belied those purposes for regulating terms and prices.⁴⁶ Economists observe that the personal lines property-casualty insurance market is easy to enter, heterogeneous, not concentrated, and prices are relatively easy to compare. They generally conclude that the market is competitive in structure and therefore — absent rate regulation — likely to be efficient.⁴⁷ Experience, as related in testimony to the 108th Congress, demonstrates that competitive markets serve purchasers of auto and homeowners' insurance better than heavily regulated markets.⁴⁸

Commercial Lines. The term “commercial lines” means property and liability insurance coverages for various business risks. The risks include direct property loss by fire or other perils, indirect property loss by interruption of business

⁴² (...continued)

Commissioners, presented by Terri M. Vaughan, Iowa Commissioner of Insurance, 107th Cong., 2nd sess., June 18, 2002, p. 4, available at [<http://financialservices.house.gov/media/pdf/061802tv.pdf>].

⁴³ Insurance Information Institute and the Financial Services Roundtable, “Insurance: Direct Premiums Written by Line, Property/Casualty Insurance, 2003,” available at [<http://www.financialservicesfacts.org/financial2/insurance/pcpbl>].

⁴⁴ For an overview of state-by-state regulation of rates, see Insurance Information Institute, “Rates and Regulation,” in *Hot Topics & Insurance Issues*, available at [<http://www.iii.org/media/hottopics/insurance/ratereg/>].

⁴⁵ Kenneth J. Meier, *The Political Economy of Regulation: The Case of Insurance*, pp. 51-54, 59-60, 64-79.

⁴⁶ Rate regulation may have been necessary historically, when insurers' rate-setting cartels were thought immune to federal antitrust laws. That is no longer true. CRS Report RL31982, *Insurance Regulation: History and Background*, by Carolyn Cobb and Baird Webel, summarizes that history.

⁴⁷ Harrington, *Insurance Deregulation and the Public Interest*, pp. 25-30.

⁴⁸ U.S. Congress, House Committee on Financial Services Committee, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, *The Effectiveness of State Regulation: Why Some Consumers Can't Get Insurance*, opening statement of Chairman Mike Oxley, House Committee on Financial Services, 108th Cong., 1st sess., Apr. 10, 2003, [<http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=205>].

or by employee misdeeds, risks of liability for products or employee actions, and risks of losses caused by someone's default or failure to perform. Accidents of history and convention subdivide these and other commercial lines coverages and give them often arcane names.⁴⁹ So, for example, the term "inland marine" refers to insurance covering risks to domestic shipments, jewelers' inventories, and accounts receivable, among other things.⁵⁰ The total net direct premium in the commercial lines market was about \$197.6 billion in 2002.⁵¹

In general, states do not regulate prices for commercial lines of insurance, other than workers' compensation insurance.⁵² Most states do regulate contract language for most types of commercial coverages,⁵³ although a few states exempt very large commercial risks from their prior approval requirements.⁵⁴ This close supervision of contracts between commercial entities has become controversial, as insurers lose market share in the risk financing marketplace, and as academics, insurers, and commercial entities discuss it as an "approval tax."⁵⁵ Some observers support continued regulation of commercial policy contract language because it protects less sophisticated businesses against fraud; others oppose it because its costs to all businesses — in terms of less innovation and greater delay — exceed its benefits to the few.⁵⁶

Workers' Compensation Insurance. Workers' compensation (workers' comp) has generally been considered a social program established to pass the costs of industrial accidents to society generally.⁵⁷ All states require employers to purchase workers' compensation insurance, providing benefits to workers injured on-the-job in substitution of tort liability. Some states have created residual markets for

⁴⁹ Vaughan and Vaughan, *Fundamentals of Risk and Insurance*, pp. 552-615.

⁵⁰ *Ibid.*, pp. 569-571.

⁵¹ Insurance Information Institute, *The I.I.I. Fact Book 2004* (Insurance Information Institute: New York, 2004), p. 33.

⁵² J. David Cummins, "Property-Liability Insurance Price Deregulation: The Last Bastion?," in J. David Cummins, ed., *Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency* (Washington: Brookings Institution Press, 2002), pp. 1-24.

⁵³ Ann F. Lavie, Assistant Vice President, Insurance Services Office, Inc., conversation with the author, Oct 9, 2003. See also Richard J. Butler, "Form Regulation in Commercial Insurance," in Cummins, ed., *Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency*, pp. 321-360.

⁵⁴ See, e.g., Maine Department of Professional and Financial Regulation, Bureau of Insurance, table of prior filing requirements for commercial general liability policies, available at [http://www.state.me.us/pfr/ins/Rate_filing_Comm_gen_liab.htm].

⁵⁵ Butler, "Form Regulation in Commercial Insurance," in Cummins, *Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency*, pp. 321-322.

⁵⁶ *Ibid.*, pp. 346-357.

⁵⁷ Vaughan and Vaughan, *Fundamentals of Risk and Insurance*, p.213.

employers unable to purchase workers' comp in their private markets.⁵⁸ A state's residual market is administered privately, by an insurer reimbursed for its administration, and its deficits are funded by proportional assessments on workers' comp insurers doing business in that state.⁵⁹

Workers' compensation insurance is the largest commercial line. In 2002, net workers' comp premiums were \$36.5 billion, or about 18.5% of the total commercial insurance market.⁶⁰ Unlike other commercial lines, most state insurance regulators generally set the rates as well as establish contract terms in both their private and residual markets for workers' compensation insurance. Workers' comp costs are rising again after dropping in the 1990s following some market reforms, including larger deductibles to improve incentives for safety.⁶¹ This has increased pressure for further reforms.⁶²

Life Insurance. Life insurers underwrite⁶³ mortality and morbidity risks of individual persons. This includes risk of financial loss by dying prematurely, by outliving one's savings, or by becoming unable to work or to care for oneself.⁶⁴ The insurance products to finance those risks are life insurance, annuity contracts, disability insurance, and long-term care insurance, respectively. In general, these are all considered personal lines coverages.

Life insurers estimate risk using a national mortality table. Though prices and terms vary insurer-to-insurer, a single life insurer doing business in 50 states wants to sell the same policy or contract everywhere. Also, unlike property-casualty insurance, states do not directly regulate the prices that life insurers charge for life

⁵⁸ Ibid., pp. 213-218.

⁵⁹ National Council on Compensation Insurance [now NCCI Holdings, Inc.], *Introduction to the Residual Market*, available at [<http://www.ncci.com/ncci/web/news/infostop/residual/overview.htm>].

⁶⁰ Insurance Information Institute, *The I.I.I. Insurance Fact Book 2004*, p. 33.

⁶¹ Ibid., p. 72. See also Joseph Shields, Xiachua Lu, and Gaylon Oswalt, "Workers' Compensation Deductibles and Employers' Costs," *The Journal of Risk and Insurance*, vol. 66, June 1999, pp. 207-218.

⁶² See Marla Dickerson, "Work-Injury Cost Savings in Doubt; An Insurance Rating Group Sees Far Less Reduction Than What Reform Legislation Backers Project," *Los Angeles Times*, Sept. 30, 2003, part 3, p. 1; Ed Mendel, "Davis Signs Workers' Comp Bill Amid Soaring Costs," *San Diego Union Tribune*, Oct. 1, 2003, p. A-3.

⁶³ The term "underwriting" means the process of selecting and classifying risk exposures. Vaughan and Vaughan, *Fundamentals of Risk and Insurance*, p. 130. Underwriting can be analogized to a manufacturing process and should be distinguished from a selling or distribution process.

⁶⁴ Classically, it also includes medical and surgical indemnity insurance or what we call "health insurance." Both life insurers and property-casualty insurers may legally underwrite health insurance; for this and other reasons, health insurance will be treated separately.

insurance or annuities.⁶⁵ States do, however, require the policy and contract forms to be filed and approved. Each state reviews the terms of each new type of policy or contract, checks how intelligible and readable it is, and otherwise assures itself that each conforms to the state's standards. It can take up to two years to get a life insurance policy form or an annuity contract form approved in all states.

The purpose of regulating individual policy forms is to protect individual consumers. A life insurance policy or annuity contract is considered "a contract of adhesion," meaning that the purchaser is considered unable to bargain with the seller over its terms. This imbalance in bargaining power and knowledge has historically justified state regulation of life and annuity policy forms. Since each state insurance regulator is charged with protecting the consumers of his or her own state, no state has been willing or able to cede its form review to another state's authority.

State insurance regulators do realize that life insurers are now competing against entities that are not subject to such a 50-state approval process.⁶⁶ Life insurers are competing with banks and with securities firms — "each industry is offering similar products, and each is marketing nationally to the same customers."⁶⁷ The NAIC has undertaken to streamline state regulation of life insurers to accommodate that reality,⁶⁸ although opinions differ about whether the NAIC and its autonomous members can make the changes necessary to adapt to that reality.⁶⁹ Unlike commercial lines, however, no overt controversy has developed about the purpose of regulating life insurance and annuities.

⁶⁵ States do mandate, however, how life insurers calculate their liabilities for life insurance and annuity contracts they issue. See Vaughan and Vaughan, *Fundamentals of Risk and Insurance*, pp. 241-252.

⁶⁶ NAIC, "Interstate Insurance Regulation Compact," available at [<http://www.naic.org/compact/index.htm>].

⁶⁷ Peter J. Wallison, "Optional Federal Chartering for Life Insurance Companies," in *Optional Federal Chartering and Regulation of Insurance*, Peter J. Wallison, ed. (Washington: AEI Press, 2000), p. 52.

⁶⁸ See NAIC, "A Reinforced Commitment: Insurance Regulatory Modernization Action Plan," dated Sept. 14, 2003, available at [http://www.naic.org/docs/regulatory_modernization_action_plan.doc].

⁶⁹ See U.S. General Accounting Office, *Insurance Regulation: Common Standards and Improved Coordination Needed to Strengthen Market Regulation*, GAO Report 03-433, (Washington: GPO, Sept. 2003), available at [<http://www.gao.gov/new.items/d03433.pdf>]. Compare with Chris Grier, "Mutual Insurer Group Wants Optional Federal Charter Off Congressional Agenda," *BestWire*, Oct. 8, 2003.

Health Insurance.⁷⁰ Individuals can finance their morbidity risk by purchasing disability income insurance and health insurance. Disability insurance payments replace some portion of an ill or injured insured person's income.⁷¹ About 80% of all disability insurance is group coverage sold by insurers.⁷² Disability insurance is regulated as health insurance, which means that all individual policies and rates must be filed with each state insurance department for prior approval. Group disability income insurance is regulated under ERISA, or under state group accident and sickness laws, as applicable.⁷³

Private insurance financed only about a third of national health expenses in 2000. About 45% of all medical expenses were publicly funded, and about 16% were paid out-of-pocket.⁷⁴ These figures — as well as enactments by Congress and the state legislatures — arguably demonstrate that our society regulates health insurance as a social program.⁷⁵

Reinsurance

Reinsurance is insurance purchased by insurance companies. Insurers buy reinsurance to limit their own losses on specific risks, to enhance their own underwriting ability, to spread losses, and to finance their own risks and growth. The insurer purchasing reinsurance is called the ceding company because it is ceding risks to the reinsurer. The reinsurer is called the assuming company because it is indemnifying — or assuming — risks from the ceding insurer. Reinsurers also buy reinsurance, which is known as “retroceding.”⁷⁶ Reinsurers operate globally, spread

⁷⁰ For details about how health insurance is regulated, see U.S. General Accounting Office, *Private Health Insurance: Federal and State Requirements Affecting Coverage Offered by Small Businesses*, GAO Report 03-1133 (Washington: GPO, Sept. 2003), available at [<http://cms.hhs.gov/charts/series/sec1.pdf>]; CRS Report RS20315, *ERISA Regulation of Health Plans: Fact Sheet*, by Hinda Ripps Chaikind; CRS Report RL31634, *The Health Insurance Portability and Accountability Act (HIPAA) of 1996: Overview and Guidance on Frequently Asked Questions*, by Hinda R. Chaikind, Jean Hearne, Bob Lyke, Stephen Redhead, and Julie Stone.

⁷¹ Vaughan and Vaughan, *Fundamentals of Risk and Insurance*, pp. 348-351.

⁷² *Ibid.*, p. 349.

⁷³ David Brenerman, Assistant Vice President of Government and Public Affairs, UnumProvident, telephone conversation with the author, Oct. 10, 2003.

⁷⁴ Centers for Medicare and Medicaid Services, U.S. Department of Health and Human Services, *The CMS Chart Series: The Nation's Health Dollar, CY 2000*, available at [<http://cms.hhs.gov/charts/series/sec1.pdf>], p. 6.

⁷⁵ See CRS Report RL31982, *Insurance Regulation: History and Background*, by Baird Webel and Carolyn Cobb; National Association of Insurance Commissioners, *Model Laws, Regulations, and Guidelines* (NAIC: Kansas City MO, 2003), vol. I, pp. 10-1 through 120-50 and vol. II, pp. 130-1 through 185-6.

⁷⁶ See Vaughan and Vaughan, *Fundamentals of Risk and Insurance*, pp. 150-152.

risk internationally, and access capital markets worldwide. In 2002 the world's 40 largest reinsurers took in total premiums of \$138.6 billion.⁷⁷

In the United States, state insurance regulators do not supervise reinsurance rates or forms. State insurance regulators do supervise the quality of each insurer's reinsurance portfolio indirectly by setting standards for when and how a ceding insurer may take credit on its statutory financial statements for reinsurance ceded. Statutory financial statements employ fixed formulas and a liquidation-type accounting basis; state regulators require them to assess U.S. insurers' solvency. If both the reinsurer and the reinsurance contract — known as a treaty — meet minimum standards that vary slightly from state to state,⁷⁸ then that reinsurance may be reported as an asset or a reduction from statutory liabilities.⁷⁹

Under these standards, a non-U.S. reinsurer that chooses not to become licensed in the United States — and thereby subject to 50-state regulation — is considered solvent only if it establishes in the U.S. a non-working trust fund equal to the gross amount of its U.S. liabilities plus at least \$20 million.⁸⁰ A trust with multiple beneficiaries must be funded in the U.S. with an amount equal to its gross U.S. liabilities plus \$100 million. The trustee assets must be cash-equivalent, and may include letters of credit.⁸¹

This state regulatory requirement applicable to non-U.S. reinsurers has become controversial. Non-U.S. reinsurers view it as discriminatory and a trade barrier, as well as an inefficient use of capital.⁸² They have proposed instead a single point-of-entry through the NAIC, which would have discretion to set the funding requirement appropriate to the financial strength of each applying insurer.⁸³ State insurance regulators and many U.S. ceding insurers seem inclined to retain the current funding requirement in their states, which they see as protecting U.S. insurers against the

⁷⁷ Charles Fleming, "European Business News: Reinsurers Get Cold Shoulder," *The Wall Street Journal Online*, Sept. 16, 2003.

⁷⁸ See National Association of Insurance Commissioners, *Model Laws, Regulations, and Guidelines* (Kansas City MO: NAIC, 2003), vol V, pp. 785-1 through 803-26 (compiling states' laws and rules on credit for reinsurance).

⁷⁹ See, e.g., Sholom Feldblum, "Reinsurance Accounting: Schedule F," *Journal of Insurance Regulation*, vol. 21, spring 2003, pp. 53-115.

⁸⁰ National Association of Insurance Commissioners, "Credit for Reinsurance Model Law," *Model Laws, Regulations, and Guidelines*, supra note 81, sec. 2.D.(3), vol. 5, pp. 785-2 and 785-3.

⁸¹ National Association of Insurance Commissioners, "Credit for Reinsurance Model Regulation," *Model Laws, Regulations, and Guidelines*, supra note 81, sec. 7.E., pp. 786-6 through 786-11.

⁸² Comité Européen des Assurances, "Reinsurance in the US: CEA Lobbying For Improved Access to US Market," *CEA Executive Update*, no. 25, Sept. 8, 2003, p. 3, available at [<http://www.cea.assur.org/cea/v1.1/actu/pdf/uk/actu117.pdf>].

⁸³ Richard Banks, "Lloyds to Press the Collateralisation Argument Again at NAIC Conference," *Insurance Day*, Oct. 14, 2003.

insolvencies of non-U.S. insurers.⁸⁴ The controversy is likely to continue, since in 2002 about 46% of all U.S. property-casualty reinsurance premiums were written by non-U.S. reinsurers unaffiliated with their U.S. cedant. The U.S. market share of non-U.S. reinsurers and their U.S. property-casualty insurance affiliates grew to 77% in 2002.⁸⁵

The September 11, 2001, terrorist attacks brought reinsurance to the attention of Congress. Once the world's reinsurers advised their cedants that new treaties would include coverage for terrorism only at an additional cost, if at all, insurers advised their policyholders similarly — and new commercial coverage for terrorism became unavailable or unaffordable. The 107th Congress responded by enacting the Terrorism Risk Insurance Act of 2002 to provide some short-term capacity and stability in the reinsurance market.⁸⁶ The act expressly preserved state regulation of insurance.⁸⁷

The September 11 terrorist attacks exacerbated concerns of the developed countries' central bankers about reinsurers' resiliency, and about the instability that their counterparty credit risks could impose on the international banking system. International-level banking, securities, and insurance supervisors had formed working groups after the Asian financial crisis in the late 1990s to consider how to promote financial market stability. Building on an informal consensus that market discipline would promote market stability, an international multi-disciplinary regulatory group had concluded in April 2001 that financial intermediaries should provide additional public information about their market, liquidity, credit, and insurance risks.⁸⁸ Subsequent to further review, the Financial Stability Forum⁸⁹ determined that lack

⁸⁴ See Reinsurance Association of America, "Reinsurance Collateral: Protecting US Consumers with Reinsurance Collateral, in *RAA Policy Update Materials*, available at [<http://community.reinsurance.org/StaticContent/Policy/ncoil.pdf>].

⁸⁵ R.J. Lehmann, "Foreign Reinsurers Continue to Take More American Premium," *BestWire*, Sept. 2, 2003.

⁸⁶ P.L. 107-297, 116 Stat. 2322 (15 U.S.C. §6701 et seq.). See CRS Report RS21444, *The Terrorism Risk Insurance Act of 2002*, by Baird Webel.

⁸⁷ P.L. 107-297, 116 Stat., pp. 2334-2335 (Sec. 106).

⁸⁸ Financial Stability Forum, "Press Release: Financial Stability Forum Reviews Vulnerabilities and Efforts to Strengthen the International Financial System," dated Sept. 4, 2002, available at [http://www.fsforum.org/press/PR_Toronto02.pdf]. For the Final Report of the Multidisciplinary Working Group on Enhanced Disclosure, see [<http://www.bis.org/publ/joint01.pdf>].

⁸⁹ The Financial Stability Forum "brings together senior representatives of national financial authorities (e.g. central banks, supervisory authorities and treasury departments), international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank. Mr Roger W Ferguson Jr, Vice Chairman of the Board of Governors of the Federal Reserve System, chairs the FSF in a personal capacity. The FSF is serviced by a small secretariat housed at the Bank for International Settlements in Basel, Switzerland." Excerpted from [http://www.fsforum.org/about/who_we_are.html].

of public information about reinsurers posed a systemic risk,⁹⁰ and it directed the International Association of Insurance Supervisors (IAIS)⁹¹ to create a template for a global database on aggregate risks in the reinsurance sector.⁹² The IAIS task force on reinsurance is expected to complete a draft template by the end of 2003, test it during early 2004, and present a final report to the Financial Stability Forum in 2004.

Conclusion

Regulation of insurers has accreted over 150 years, as courts and policymakers have responded to needs in local economies, and later in aspects of the national economy. State and national policymakers are now considering how to respond to new economic demands on the financial intermediation that insurers perform. At issue is the definition of those demands, as a preface to addressing the economic policy issues emerging globally. Society, insurers, and consumers all have policy needs, which Congress is working to address.

⁹⁰ Financial Stability Forum, press release dated September 4, 2002, available at [http://www.fsforum.org/press/PR_Toronto02.pdf].

⁹¹ IAIS is a voluntary association of insurance supervisory officials from over 100 countries. See [<http://www.iaisweb.org/>].

⁹² See Press Release, *supra* note 93, pp. 2-3.