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The Past and Future of Insurance Regulation: The McCarran-Ferguson Act and Beyond

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Martin F. Grace
James S. Kemper Professor
Department of Risk Management and Insurance
Georgia State University

Robert W. Klein
Associate Professor of Risk Management and Insurance,
and Director of the Center for Risk Management and Insurance Research
J. Mack Robinson College of Business, Georgia State University

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Martin F. Grace
Robert W. Klein

Center for Risk Management & Insurance Research
Georgia State University

Contact Information:
Robert W. Klein
Center for RMI Research
Georgia State University
P.O. Box 4036
Atlanta, GA 30302-4036
Tel: 404-413-7471
E-Mail: rwklein@gsu.edu

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Abstract

This paper examines the system of insurance regulation in the US and how it might evolve in the future given its political-economic environment and proposals for increasing the role of the federal government. Insurance is primarily regulated at the state level and states' regulatory authority has been reaffirmed on several occasions over its history, including the passage of the McCarran-Ferguson Act (MFA) in 1945. The MFA also established a limited antitrust exemption for insurers which is coordinated with its regulation. However, as the insurance industry has evolved, its support for state regulation has eroded and many insurers now support the creation of an Optional Federal Charter (OFC) for insurers that would preempt state regulation for federally-chartered companies. The OFC would also modify antitrust law for insurers. Further, the industry and many academics advocate the reform of insurance regulatory polices. The proposals for changes in the insurance regulatory framework and its policies raise a number of significant issues and have sparked a fierce debate among different stakeholders. We review the context for this debate and discuss reform proposals and their prospects for enactment. We also assess the implications of modifying insurance antitrust law in the context of alternative regulatory frameworks and policies.

I. Introduction

Insurance regulation in the US has been steeped in controversy over its 200-year history. In its early years, industry and regulatory failures prompted reforms and the coalescence of insurer oversight into a state regulatory framework. Beginning in the mid-1800s, both the industry and its state regulators have been subject to a series of federal challenges. The states' regulatory authority was reaffirmed in these challenges, most recently with the passage of the McCarran-Ferguson Act (MFA) in 1945. The MFA also established a limited antitrust exemption for insurers which is coordinated with its regulation. However, as the insurance industry has evolved its support for state regulation has eroded and many insurers now support the creation of an Optional Federal Charter (OFC) for insurers that would preempt state regulation for insurers regulated by the

federal government and also modify antitrust law and policy for insurers. An OFC is strongly opposed by the states as well as certain industry groups (e.g., independent agents) with a vested interest in preserving the existing system and a fierce debate continues over the restructuring of the insurance regulatory framework and its policies. Questions also have been raised about the implications of eliminating or narrowing the industry's limited antitrust exemption in OFC legislation.

This paper examines the system of insurance regulation in the US and how it might evolve in the future given its economic and political environments and proposals for increasing the role of the federal government and other reforms. It is important to understand the historical evolution of insurance regulation, its current structure and the interplay of economic and political factors to dissect the current debates and the merits of proposed reforms. We review these various aspects of insurance regulation and proposed reforms and discuss their prospects. We also assess the implications of modifying insurance antitrust law in the context of alternative regulatory frameworks and policies.

Section II articulates a basic set of economic principles that should guide the regulation of insurance and any changes to it. This is followed by an overview of the history of state insurance regulation and its current framework. In Sections V and VI we discuss potential policy and institutional reforms and the implications of altering the industry's antitrust status. Section VII summarizes and concludes our analysis.

II. Economic Principles for Insurance Regulation

A. The Rationale for Insurance Regulation

The economic foundation for regulation is based on the possibility (or realization) of market failures (see, for example, Spulber, 1989; Viscusi, Vernon and Harrington, 2000). These market failures are judged against the social welfare maximizing conditions for perfect competition. Perfect competition requires many buyers and sellers in a market, free entry and exit, perfect information, prices determined by the interaction of supply and demand, and a homogenous product. Under these conditions, the joint surplus or gains from trade of producers and consumers is maximized. In assessing the need for and benefits of regulation in an imperfect world, markets are often judged against a standard of "workable competition" which reasonably approximates the conditions for perfect competition to the degree that government intervention can not improve social welfare (Scherer and Ross, 1990).

Potential market failures in insurance include severe asymmetric information problems and principal-agent conflicts which could lead some insurance companies to incur excessive financial risk and/or engage in abusive market practices that harm consumers. Insurance consumers, particularly individuals and households, face significant challenges in judging the financial risk of insurers and properly understanding the terms of insurance contracts. There is also the possibility that insurers could acquire sufficient market power to restrict competition, resulting in barriers to entry, higher prices and excessive economic profits.

In contrast to market failures, there are a set of circumstance we term "market problems." These are not failures in the economic sense but constitute "undesirable"

market outcomes, e.g., high prices, the unavailability of insurance coverage, etc., that result from conditions affecting the cost of risk, rather than violations of the conditions for perfect or workable competition. For example, in some markets insurance may be expensive because claim costs are high. One would expect the price of insurance to be commensurate with expected claims costs. While this may cause hardships for consumers, it is a natural result of properly-functioning market forces and not a condition that can be remedied by regulation per se.

We contrast this kind of situation with true market failures where there is a significant violation of the conditions for workable competition. The rationale for government intervention when market failures occur is based on promoting or restoring economic efficiency. For example, an insurer may take on too much financial risk because its owners would not be required to pay the full costs of its insolvency due to limited liability of the corporate form of organization. In many industries, the creditors of firms may be able to sufficiently judge their financial risk and take steps to protect their interests. However, the circumstances for certain financial institutions such as banks and insurance companies are arguably more severe. In the case of solvency or financial regulation of insurance companies, one could argue that the cost of monitoring are so high for consumers that it is cheaper for the government to undertake this task and take action against insurers that incur excessive financial risk. If it is more efficient for the government to perform this monitoring and undertake other compliance/enforcement measures, then regulatory intervention is welfare-enhancing.

Similarly, if there is collusion among insurers due to market power resulting from the presence of a small number of firms and entry barriers in a particular market, then the

government could remedy this market failure through antitrust measures or regulating prices. The assumption here is that the government would ensure that the prices charged would be same as those that would be set in a competitive market. This is an efficiency-based argument where the regulator would attempt to enforce prices equal to marginal costs. If, in contrast, high insurance prices are due to high levels of risk then regulation cannot enforce lower prices without causing market distortions.[1] This distinction is important because regulatory intervention and policies often can be motivated by the desire to "fix" or ameliorate market problems rather than remedy legitimate market failures.

Optimal regulation is based upon an ideal set of policies that attempt to replicate the conditions of a competitive market and maximize social welfare. This theoretical model of regulation is primarily intended to remedy market failures and not market problems caused by other external forces. This may include failures that would otherwise cause insurers' to incur an excessive risk of insolvency and/or engage in abusive trade practices, e.g., misrepresenting insurance products, refusing to pay legitimate claims, etc. This assumes that regulators have perfect information and can determine and implement the correct market solutions. Not all market failures can necessarily be remedied by regulation.

1. Solvency Regulation

[1] Arguably, this is the problem in Florida. Property insurance prices are high in Florida due to the relatively high probability of hurricanes and catastrophic losses. This raises expected claims costs as well as insurers' cost of capital given the high degree of uncertainty and volatility associated with offering insurance coverage for hurricane losses. If the cost of capital rises, price regulation reduces incentives for insurers to commit capital to the market. In addition, it results in an availability crisis since there are fewer insurers willing to offer coverage under such constraints.

The social welfare argument for the regulation of insurer solvency derives from inefficiencies created by costly information and principal-agent problems (Munch and Smallwood, 1981).[2] Owners of insurance companies have diminished incentives to maintain a high level of safety to the extent that their personal assets are not at risk for unfunded obligations to policyholders that would arise from insolvency. The argument is that it is costly for consumers to properly assess an insurer's financial strength in relation to its prices and quality of service.[3] Insurers also can increase their risk after policyholders have purchased a policy and paid premiums – a "principal-agent" problem that may be very costly and difficult for policyholders to control.

There are other aspects of excessive insolvency risk that may motivate regulatory intervention. Financial regulators are also concerned about "contagion" and the possibility that a spike in insurer insolvencies could induce a "crisis of confidence" that may have negative effects on the industry. Further, there may be negative externalities associated with excessive insurer insolvency risk. The costs of unpaid claims may be shifted beyond policyholders to their creditors. Hence, it is common for the regulation of financial institutions to be coupled with some form of insolvency guarantees (e.g., deposit insurance, insurance guaranty associations, etc.) that cover at least a portion of the obligations of bankrupt institutions.

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[2] Costly information refers to the fact that it is costly for consumers to acquire information about the financial condition of an insurer and the relative value of its products in relation to their prices. Principal-agent problems refer to the difficulty that a consumer (the principal) faces in monitoring and controlling the activities and financial risk of an insurer, once the consumer has signed a contract with the insurer and paid premiums for coverage of future claims and benefit obligations.

[3] The costs of determining financial soundness are much lower today than they were in the past as anyone with knowledge and access to the Internet can check an insurer's claims paying ability - provided by rating agencies - on the Internet. However, rating agencies cannot engage in enforcement actions (although they may pressure insurers to correct problems) and most countries do not accept the notion that they are an adequate substitute for government regulation.

The goal of optimal insurance solvency regulation is not to minimize insolvencies as that would be quite costly. Instead a more reasonable goal is to minimize or limit the social cost of insurer insolvency within acceptable parameters (Grace, Klein, and Phillips, 2002). The social cost is more than merely the lost equity of the insurer as it includes the effects on policyholders and third parties who may be creditors of insurers. Regulators limit insolvency risk by requiring insurers to meet a set of financial standards and taking appropriate actions if an insurer assumes excessive default risk or experiences financial distress (See, for example, Cummins, Harrington, and Klein, 1995).

2. Price Regulation

There are two potential rationales for regulation of insurance prices. The traditional explanation for regulation of insurance prices involves costly information and solvency concerns (Joskow, 1973; Hanson, Dineen, and Johnson., 1974). According to this explanation, insurers' incentive to incur excessive financial risk and even engage in "go-for-broke" strategies may result in inadequate prices. Some consumers will buy insurance from carriers charging inadequate prices without properly considering the greater financial risk involved. In this scenario, poor incentives for solvency safety could induce a wave of “destructive competition” in which all insurers are forced to cut their prices below costs to retain their market positions.[4] The solution offered was uniform prices developed by industry rating organizations subject to regulatory oversight to prevent excessive prices.[5]

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[4] This view likely stems from the periodic price wars (and subsequent insurer failures) that afflicted property-casualty insurance markets during the 1800s and early 1900s.
[5] This is discussed more fully in Section VI detailing the adoption of the McCarran-Ferguson Act.

This view essentially governed insurance rate regulation until the 1960s, when states began to disapprove or reduce price increases in lines such as personal auto and workers' compensation insurance. The rationale that some might offer for government restrictions on insurance price increases is that consumer search costs impede competition and lead to excessive prices and profits.[6] It also might be argued that it is costly for insurers to ascertain consumers' risk characteristics accurately, giving an informational advantage to insurers already entrenched in a market and creating barriers to entry that diminish competition. According to this view, the objective of regulation is to enforce a ceiling that will prevent prices from rising above a competitive level and to protect consumers against unfair market practices. In addition, the public may express a preference for regulatory policies to lower or cap insurance prices consistent with social norms or objectives.[7]

However, the empirical evidence does not tend to support a case for the regulation of insurance prices in the current environment. Studies of insurance markets indicate that they are highly competitive in terms of their structure and performance (Cummins and Weiss, 1991, Klein, 1995 and 2005, and Grace and Klein, 2007). Entry barriers tend to be low and concentration levels rarely approach a point that would raise concerns about insurers' market power. Further, long-term profits in insurance markets tend to be in line with or below the rates of return earned in other industries (Insurance Information Institute, 2007). We should also note that over the last 50 years, enforcement of uniform

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[6] Harrington (1992) explains but does not advocate this view. Further, the cost of shopping for insurance has dropped dramatically for personal lines of coverage (see Brown and Goolsbee, 2002).

[7] For example, most states have determined that drivers should carry some form of liability or no-fault auto insurance. Because of this requirement, some policymakers believe that the government should ensure that insurance coverage is reasonably available and affordable for those who are required to purchase it. This argument has been used to justify strict controls on auto insurance rate increases in some jurisdictions.

rates eroded and industry organizations moved to the promulgation of "advisory" rates or loss costs and insurer pricing became much more independent and differentiated. Hence, it is not surprising that studies of the effects of the regulation of insurance rates have not uncovered significant benefits to consumers from such regulation (See, for example, Harrington, 2002).

3. Market Conduct Regulation

A stronger case can be made for regulating certain insurer market practices, such as product design, marketing and claims adjustment. Constraints on consumer choice and unequal bargaining power between insurers and consumers, combined with inadequate consumer information, can make some consumers vulnerable to abusive marketing and claims practices of insurers and their agents.[8] There have been numerous instances where insurance products have been misrepresented and insurers or their agents have been found guilty of sales abuses. Many life insurers settled cases in the late 1980s and early 1990s for agent practices which took customers out of safe policies and put them in inappropriate (high risk) policies.[9] Although prominent insurers were involved in some of these cases, the greater threat probably lies with firms or agents that are not highly motivated to establish and maintain a strong reputation for fair dealings with consumers. Hence, regulators need to be especially vigilant for "bad actors" that seek gains from abusive or fraudulent transactions.

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[8] It is true that consumers subject to unfair treatment might seek remedies through the courts and sometimes do so. However, legal remedies may not be feasible for consumers with limited resources and bills to pay. Also, it may be difficult to secure financial damages from some fraudulent insurers.

[9] What is interesting about this example is that the sale practices were not discovered by regulators until after the initial lawsuits were brought.

As a result of the market conduct scandals of the 1980s, many life insurers joined a voluntary self-regulator organization (SRO) called the Insurance Marketplace Standards Association (IMSA). Insurers were concerned that new regulatory rules would be inefficient and fail to restore consumer confidence and trust in the life insurance industry. They believed that an SRO would be a more efficient and effective mechanism to address market conduct problems. Evidence suggests that IMSA has reduced the costs of market conduct problems while at the same time increasing firm value (see Grace and Klein, 2007). Thus, while there is evidence of potential market failures in insurer and agent behavior, the industry has undertaken steps to reduce the costs of the problem while regulators continue to struggle with developing rules and compliance mechanisms intended to achieve the same objectives.[10]

4. Externalities

It is possible that the presence or absence of insurance causes an externality. For example, if terrorism insurance is expensive it causes individuals to invest in self protection. It is possible that the aggregation of the economy's self-protection expenditures would be more expensive that the cost of insurance. The private market, however, cannot obtain capital to back terror risks except at a relatively high cost. Individuals therefore do not purchase terror coverage. A government subsidy could solve this problem. By reducing the cost of risk to insurers, the insurers then can provide insurance to a broader section of the market. This would reduce the individual incentive

[10] See Klein (2005) for a more detailed discussion of regulatory efforts to better police marketing and sales activities. The challenge faced by regulators is that rules tend to be somewhat arbitrary and cannot fully accommodate the variety of circumstances encountered in insurance transactions. Further, monitoring compliance with such rules can be difficult and costly given the large volume of transactions.

to purchase the more costly self-protection services. This type of intervention requires that the cost of the subsidy to society is less than the cost of the self-protection (Lakdawalla and Zanjani, 2005). We should note, however, that the conditions that would support some form of government insurance or reinsurance tend to be unusual and would not apply to most risks. The greater externality concern for regulators is the circumstances that would lead to a high number of insurer insolvencies and the rippling costs of such insolvencies.

In sum, optimal regulation should be designed to minimize the cost of insurer insolvencies, promote the pricing of insurance at marginal cost, promote reasonable trade practices, provide appropriate incentives for insurers to police their own practices and those of their agents, and provide the optimal amount of insurance. However, optimal regulation depends upon more than just the approach to regulation. It also depends upon the structure. The US continues to rely on a state-based system of insurance regulation. This creates problems as multistate insurers are subjected to multiple regulatory standards which impose additional costs.

B. An Optimal Regulatory Structure

An optimal regulatory system for insurance would remedy legitimate market failures in the most efficient manner possible. This implies that the regulatory framework and specific interventions should be "welfare-enhancing." More specifically, the preferred regulatory framework and policy set would be those which would maximize social welfare by implementing sufficient remedies that would minimize regulatory compliance costs and market distortions. From an economic perspective, regulators

would seek to achieve the outcomes which would be produced by a workably competitive market.

The states are not well-positioned to achieve these objectives. They vary greatly in terms of size and resources. A state-based system cannot achieve maximum economies of scale and the larger states' regulation of their domestic insurers creates positive externalities for other states. The optimal structure of regulation would to place the level of regulation where all the benefits and costs of regulation are internalized to the population being regulated. For example, if the benefits and costs of regulation are imposed on a relatively small geographic area (like a county), then the proper level of regulation would be the level of the county. In contrast, if the benefits and costs of regulation are spread nationwide, then the federal government (or some interstate compact) would be optimal (Inman and Rubenfeld, 1997).

A strong argument can be made that a federal regulatory framework would be the most efficient for overseeing the solvency of insurers operating in multiple states. A federal system would offer significant economies of scale and its resources could be deployed in the most effective way to ensure that an insurer maintains it financial risk within reasonable bounds. Grace and Phillips (2007) find evidence of trans-state externalities in the current system, as states with small domestic insurance markets are less efficient producers of insurance regulation and appear to allow states that choose to expend the greatest resources to regulate for them. In addition, aggregating the states up to some regional arrangement like census divisions does not completely contain the externality caused by the "smaller" regions letting the "bigger" regions regulate insurance.

There are also other costs of multistate regulation. Grace and Klein (2000) find that multiple state licensing is costly. In turn, Pottier (2007) finds significant inefficiencies in the life insurance industry attributable to state regulation. Finally, Regan (2007) finds that multistate licensing is costly to insurance agents. This evidence suggests that there are significant efficiency costs to multistate firms subject to state regulation.[11]

An insurer's financial structure does not vary across the states in which it operates and, hence, it should be required to adhere to one set of standards enforced by a single regulatory agency. Economic arguments for federal regulation of an insurer's market practices are less obvious but a strong case can be made nonetheless. First, there is close link between an insurer's market practices and its financial condition and, ideally, their regulation would be best coordinated by one agency. Second, an insurer's market practices are unlikely to vary across states and a federal regulator could more effectively remedy market abuses that cross state lines. Third, consumer protection needs should be similar wherever an insurer operates and, hence, insurers should be subject to a common set of standards. Fourth, and very importantly, compliance costs would be lower if insurers are subject to one set of standard administered and enforced by a single regulator. However, state regulators challenge such arguments and contend that they are closer and more responsive to the needs of their consumers.

[11] An alternative described in Harrington (2006) would allow an insurer to choose a state to regulate the firm. All interactions between consumers and the insurer would be governed by the chartering states law. This approach solves the individual insurers compliance cost problem with multiple state regulators just as a federal approach does. In addition, it allows for competition between states much like seen in the market for corporate charters.

C. Social Preferences and Politics

Another aspect of regulation in practice is how the government intervenes in insurance markets. The political economy of regulation is characterized by groups vying for policies that favor their economic interests. Some groups may be relatively small but have relatively substantial and concentrated economic interests. They may tend to prevail on issues that are opaque and not salient to the majority of consumers. Other issues, such as the price of auto and home insurance, may be highly salient to many consumers. Thus, a number of factors could affect regulatory policies in a given area.[12]

Insurance has been described as an industry that is "vested with the public interest." This statement implies that insurance is important to the welfare of households, firms and the overall economy and warrants close government attention and intervention. It also implies that the public interest should be the paramount consideration in guiding government intervention, but it is not really clear who the "public" are. Low prices, for example, might benefit consumers in the short-run until firms leave the market and the supply of insurance evaporates. This artificially-induced shortage of insurance coverage would not seem to be in the public interest, but there could be strong political support for lower prices regardless.[13] Politicians (and regulators) may exploit voters' lack of knowledge of the basic economics of insurance markets in prosecuting such policies.

This public interest view implies that insurance is an essential service that is necessary for the proper functioning of the economy and ensuring the welfare of households and firms. Therefore, both the public and government officials will devote

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[12] See Meier (1988) and Klein (1995) for discussions of theories of regulatory behavior and how they apply to insurance.

[13] For example, California voted to cut insurance prices 20 percent in a popular referendum called Proposition 103. See e.g. California Insurance Department website. http://www.insurance.ca.gov/0500-about-us/0500-organization/0400-rate-regulation/prop-103.cfm.

considerable attention to insurance markets and their regulation. The use of this term was historically confined to solvency regulation but, arguably, has been extended over time to other aspects of insurance markets (Eling, Schmeiser, and Schmit, 2007). With respect to solvency issues, insurance may not be significantly different than banking and other important financial services. However, the breadth of insurance needs and products arguably present a level of complexity that is greater than that found in most other regulated industries. This breadth and complexity can lead to more extensive government intervention that extends beyond solvency issues and policies that favor social preferences that may or may not be consistent with the principles of regulation articulated above.

These social preferences manifested through political choices can influence regulatory and government policies. One example is the attempt to constrain insurance price levels or price differences among different groups of insureds. Such a policy can appeal to consumers if they believe that insurers will otherwise charge excessive prices or they do not understand the basis of risk-based pricing structures. However, price constraints markets can lead to problems of adverse selection as well as moral hazard. Imposing and sustaining cross-subsidies can be very difficult in private markets where buyers have choices as to how much insurance they purchase and the insurers they purchase it from.[14]

Another example of how social preferences can influence policy is the requirement that insurers offer certain types of coverage to every applicant. Such mandatory offer requirements are typically justified on the basis that insurance is an

[14] See Worrall and Cummins (2002) for a discussion of the experience in the New Jersey auto insurance market.

"essential" service. However, this plays havoc with an insurer's need to manage its portfolio of exposures and avoid risks that are uninsurable or that cannot be accommodated within its rate structure. Mandatory offer requirements coupled with price constraints can be particularly problematic.

Ultimately, to sustain prices below that which would be set in a competitive market, subsidies are required which necessitate some form of government "tax" on all insurance consumers and/or taxpayers. Unfortunately, most attempts to override the risk-based pricing of insurance and impose subsidies are opaque to those who bear the burden or the negative effects of such policies.[15] These are the circumstances where imperfect public choice mechanisms most often result in economic outcomes that not only diminish social welfare but also are at odds with voters' long-run economic interests as they create other market problems and lead to higher insurance costs for all consumers.

III. A Brief History of Insurance Regulation

A. Early Origins

The current state regulatory framework for insurance has its roots in the early 1800s when insurance markets were generally confined to a particular community.[16] Local stock companies and mutual protection associations formed to provide fire insurance to property owners in a city. The high concentration of risk and the occurrence of large conflagrations led to highly cyclical pricing and periodic shakeouts when a

[15] See Harrington and Doerpinghaus (1993) for an in depth analysis of this problem in auto insurance.

[16] See Daly (1970), Hanson, Dineen, and Johnson (1974), Lilly (1976) and Meier (1988) for more detailed reviews of the history of state insurance regulation.

number of property/casualty companies would fail after a major fire (Hanson, Dineen, and Johnson, 1974). Life insurers became notorious for high expenses, shaky finances and abusive sales practices (Meier, 1988). The local orientation of insurance markets at the time led municipal and state governments to establish the initial regulatory mechanisms for insurance companies and agents.

Government control of insurers was initially accomplished through special legislative charters and discriminatory taxation, but this proved to be an inefficient mechanism as the number of companies grew and the need for ongoing oversight became apparent (Meier, 1988). Insurance commissions were then formed by various states to license companies and agents, regulate policy forms, set reserve requirements, police insurers' investments, and administer financial reporting. Price regulation was essentially confined to limited oversight of property-casualty industry rate cartels.

Early on, the states recognized the need to coordinate their insurance regulatory activities. This led to the formation of the National Association of Insurance Commissioners in 1871. Its initial activities primarily focused on the development of common financial reporting requirements for insurers. State regulators also used the NAIC as a vehicle for discussing common problems and developing model laws and regulations which each state could modify and adopt according to its preferences.

Through the years, insurance department responsibilities grew in scope and complexity as the industry evolved. Two major forces appear to have heavily influenced the evolution of insurance regulatory functions and institutions. One factor has been the increasing diversity of insurance products and the types of risks that insurers have assumed. The other factor is the geographic extension of insurance markets with a

number of carriers operating on a national and international basis. A third and more recent development has been significant consolidation within the life, health and property-casualty sectors as insurers have merged to achieve greater economies of scale and increase their financial capacity. Tables III.1 and III.2 summarize basic trends in the property-casualty and life-health insurance sectors that document the industry's transformation.

Arguably, the state regulatory framework is heavily challenged by such developments. Every state has had to increase its resources and expertise to oversee a more complex and geographically-extended industry. The states' reliance on the NAIC also has necessarily increased as a vehicle to pool resources and augment their regulatory activities. Consequently, the NAIC has been transformed into a major service provider as well as a mechanism for coordinating state actions and centralizing certain regulatory processes. Although the states have substantially increased their resources and the sophistication of their regulatory mechanisms, their critics raise concerns about the inherent inefficiency of a state-based framework and its ability to keep pace with the industry.

B. The State versus Federal Regulation Debate

Tension between the federal government and the states over the regulation of insurance dates back to the mid-1800s. This tension is created by the interstate operation of many insurers and their significant presence in the economy. On several occasions, the federal government has sought to exert greater control over the industry and the states have fought back aggressively to hold on to their authority, backed by the insurance industry. The economic and political stakes are high for both sides. The primacy of the

states' authority over insurance was essentially affirmed in various court decisions until the Southeastern Underwriters case in 1944. In that case, the U.S. Supreme Court ruled that the commerce clause of the U.S. Constitution did apply to insurance and that the industry was subject to federal antitrust law. This decision prompted the states and the industry to join forces behind the passage of the McCarran-Ferguson Act (MFA) in 1945 which delegated regulation of insurance to the states, except in instances where federal law specifically supersedes state law. The MFA also granted a limited antitrust exemption to insurers tied to compensating regulatory oversight by the states.

Despite the passage of the MFA, federal interest in insurance regulation has continued to grow over time for several reasons. First, the insurance industry continues to play an important financial role in the nation's economy. Second, the performance of insurance markets affects interstate commerce and a number of areas of public policy staked out by the federal government, such as environmental pollution and health care. Third, periodic crises, such the spike in insurer insolvencies in the 1980s, have fueled concerns about the adequacy of state insurance regulation and prompted debate about whether federal intervention would be necessary and efficient to remedy industry failures. Fourth, considering the vast resources commanded by the industry, it is only natural that some members of Congress might favor a stronger federal role in insurance in order to increase their authority and influence.

Historically, the industry strongly supported state over federal regulation. However, in recent years this has changed as the industry has continued to evolve. Increasingly, many insurers – especially those that operate on a national basis – have come to favor some form of federal regulation, such as an OFC. These insurers have

become increasingly frustrated with the additional costs and burdens that they associate with the state system. They perceive, with considerable justification that it would be less costly and more efficient for them to deal with one central regulator than 56 jurisdictions.[17] Insurers advocating federal regulation have not been satisfied with the states' efforts to "harmonize' and streamline their regulation that can only go so far before they undermine the states' arguments for preserving a state-based system. We should note, however, that the industry is not unanimous in its support of federal regulation. Many state and regional insurers, along with local agents, continue to support the state framework.

Although the primary regulatory authority for insurance still resides with the states, the federal government has affected state insurance regulatory policy and institutions in several ways. In a number of instances, Congress has instituted federal control over certain insurance markets or aspects of insurers' operations that were previously delegated to the states. In other cases, the federal government has established insurance programs which are essentially exempt from state regulatory oversight. Even the threat of such interventions has spurred the states to take actions to forestall an erosion of their regulatory authority.

The federal government also has set regulatory standards which the states are expected to enforce. In the case of Medicare supplement insurance, for instance, Congress enacted loss ratio standards which the states were required to adopt to avoid relinquishing their oversight authority to the federal government. Additionally, Congress also has significantly constrained state regulatory control over certain types of insurance entities, such as risk retention groups and employer-funded health plans, in order to

[17] See Pottier (2007) and Grace and Klein (2007).

increase coverage options in markets where the cost of traditional insurance is high. Finally, federal policies in a number of other areas such as antitrust, international trade, law enforcement, taxation and the regulation of banks and securities have significant implications for the insurance industry and state regulation.

The most recent manifestations of the push for federal regulation are proposals for federal regulatory standards and an Optional Federal Charter (OFC) for insurers that choose to be federally regulated. The states oppose both proposals, with their strongest opposition aimed at an OFC. They perceive that many insurers would choose an OFC which would effectively remove a large part of the industry from state oversight. State-oriented insurers and agent groups also strongly oppose an OFC, recognizing that it would reduce state entry barriers and enhance the competitive position of national insurers and producers. The OFC proposal is now the central focus of the state versus federal regulation debate.

C. The Evolution of State Insurance Regulation

Insurance regulation has been greatly affected by and compelled to evolve in response to changes in the industry and its economic and financial environment. One wave of reforms began in the late 1980s that were primarily aimed at strengthening solvency regulation. A large spike in the number and cost of insurer insolvencies (see Figures III.1 and III.2) in the mid-1980s led to an intensive Congressional investigation and a number of state regulatory initiatives. These initiatives included the strengthening of insurer financial standards, risk-based capital requirements, improved financial monitoring systems, and a program for certifying the adequacy of each state's solvency

regulation. As insurer insolvencies fell, Congressional scrutiny diminished and the immediate threat to the state system seemed to subside.

However, growing industry complaints about the inefficiency and high cost of outmoded state regulatory policies warranted attention. This led to a second wave of state/NAIC initiatives that continue through the present. The objective of these initiatives has been to streamline and harmonize state regulatory policies and practices to lessen regulatory cost burdens on insurers (and coincidentally ease the pressure for federal regulation).

The states' efforts in this area have progressed in several phases. Beginning in the mid-1990s, the NAIC's Special Committee on Regulatory Re-Engineering identified several areas that warranted review, including company admission/licensing; special deposit requirements; countersignature requirements; deregulation of commercial lines; rate and form review; and other measures to improve the regulatory services received by insurance consumers. The committee issued a white paper in 1998 presenting its analysis and recommendations for further action by the relevant NAIC committees and the individual states. This was followed by subsequent NAIC reports in 2000, 2003 and 2005 that assessed the states' progress and set forth objectives for further improvements in the national system of state-based insurance regulation.[18]

During this period, several initiatives ensued or gained increased momentum, including:

- Enhanced consumer protection, encompassing the Consumer Information Source (CIS) Web site.

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[18] These reports are *Statement of Intent – The Future of Insurance Regulation* (March 2000), *A Reinforced Commitment: Insurance Regulatory Modernization Action Plan* (September 2003) and 2005 Regulatory Initiatives: Goals, Action Plans and Deadlines for States, Committees and NAIC Staff (March 2005).

- More efficient market regulation, encompassing the *Market Analysis Handbook*.

- "Speed to Market for Insurance Products," encompassing the Interstate Insurance Product Regulation Compact and the System for Electronic Rate and Form Filing (SERFF).

- Uniform forms and processes for producer licensing, encompassing the National Insurance Producer Registry (NIPR).

- Standardized insurance company licensing, encompassing the Uniform Certificate of Authority Application (UCAA).

- Improved solvency regulation, encompassing the Financial Data Repository (FDR).

- Streamlined changes of insurance company's control, encompassing the Form A Database.

In June 2004, the NAIC issued a "roadmap" that identified 15 areas where it believes national standards can be implemented by the states to provide a streamlined and seamless system of effective insurance regulation across the United States. The areas identified include:

- Market Conduct Uniform Standards
- Company Licensing
- Agent Licensing
- Life Insurance
- Property/Casualty Commercial Insurance
- Property/Casualty Personal Lines
- Surplus Lines
- Reinsurance
- Antifraud Network
- McCarran-Ferguson Antitrust Exemption and Rate Regulation
- State-National Insurance Coordination Partnership
- Viatical Settlements
- Interstate Compact for Health Insurance Products
- Enhancing Financial Surveillance
- Receivership

While these initiatives are impressive, they have failed to satisfy many insurers' demand for a true national regulatory system. It is difficult to see how insurers' desire for a common regulatory system can be reconciled with the state's desire to retain their individual authorities to regulate insurers and insurance markets.

IV. Current Framework for Insurance Regulation

A. Structure

The regulatory framework is not confined to insurance departments but extends to all levels and branches of government. The major authorities in the current regulatory system are: 1) state insurance departments; 2) the courts; 3) state legislatures and the Congress; and 4) the executive branch at the state and federal level. Insurance has the additional complexity of both federal and state government authorities which are involved in the regulation of the industry. The National Association of Insurance Commissioners (NAIC) also plays a significant role in the system.

The state legislature establishes the insurance department, enacts insurance laws and approves the regulatory budget. Insurance departments are part of the state executive branch, either as a stand-alone agency or as a division within a larger department. Commissioners must often utilize the courts to help enforce regulatory actions, and the courts in turn, may restrict regulatory action. The insurance department must coordinate with other state insurance departments in regulating multistate insurers and rely on the NAIC for advice as well as some support services. The federal government overlays this

entire structure, currently delegating most regulatory responsibilities to the states, while retaining an oversight role and intervening in specific areas.[19]

Most commissioners are appointed by the governor (or by a regulatory commission) for a set term or "at will," subject to legislative confirmation. Typically, the governor and other higher administration officials do not interfere with daily regulatory decisions, but may influence general regulatory policies and become involved in particularly salient issues. Twelve states elect their insurance commissioners who are more autonomous in the sense that they are not appointed by their governors but they must still cooperate with the administrations and legislatures in their states in order to achieve their objectives. Regulatory policy is formulated collectively by the insurance commissioner and the administrative branch, the legislature and the courts.

B. Regulatory Functions

Insurance regulatory functions can be divided into two fundamental areas: 1) financial or solvency regulation; and 2) market regulation.[20] Beyond these two fundamental areas, state insurance departments engage in certain other activities, such as providing consumer information, to facilitate competition and better market outcomes. Such activities can be important in promoting regulatory objectives and potentially lessening the need for more intrusive regulatory constraints and mandates. Below we briefly summarize the important aspects of financial and market regulation and discuss specific regulatory policies in greater detail in Section V. Figure IV.3 diagrams the most important insurance regulatory functions.

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[19]In practice, the federal government has left the principal regulatory functions for insurance to the states.
[20] See Klein (1995) and (2005) for a more detailed overview of insurance regulatory functions.

Protecting policyholders and society in general against excessive insurer insolvency risk should be the primary goal of insurance regulation. Regulators protect policyholders' interests by requiring insurers to meet certain financial standards and to act prudently in managing their affairs. To accomplish this task, insurance regulators are given authority over insurers' ability to incorporate and/or conduct business in the various states. State statutes set forth the requirements for incorporation and licensure to sell insurance. These statutes require insurers to meet certain minimum capital and surplus standards and financial reporting requirements and authorize regulators to examine insurers and take other actions to protect policyholders' interests. Solvency regulation polices a number of aspects of insurers' operations, including: 1) capitalization; 2) pricing and products; 3) investments; 4) reinsurance; 5) reserves; 6) asset-liability matching; 7) transactions with affiliates; and 8) management. It also encompasses regulatory intervention with insurers in financial distress, the management of insurer receiverships (bankruptcies), and insolvency guaranty mechanisms that cover a portion of the claims of insolvent insurers.

The primary responsibility for the financial regulation of an insurance company is delegated to the state in which it is domiciled. Other states in which an insurer is licensed provide a second level of oversight but, typically, non-domiciliary states do not take action against an insurer unless they perceive the domiciliary state is failing to fulfill its responsibility. The states use the NAIC to support and coordinate their solvency oversight and compel domiciliary regulators to move more quickly in dealing with distressed insurers if this proves necessary. This helps to remedy (but may not fully correct) the negative externalities associated with solvency regulation. An insurer's

domiciliary state tends to reap the lion's share of the direct economic benefits of its operations (e.g., employment and payrolls) but the costs of its insolvency are distributed among all the states in which it operates[21]. Economic and political considerations could cause a domiciliary regulator to exercise too much forbearance in dealing with a distressed insurer.

The regulation of an insurer's market practices is principally delegated to each state in which it operates. Hence, each state effectively regulates its insurance markets. The scope of market regulation is broad (potentially encompassing all aspects of an insurer's interactions with consumers) and the states' policies can vary significantly. State regulation of insurers' prices or rates is a particularly visible and controversial topic. The rates for personal auto insurance, homeowners insurance and workers' compensation insurance are subject to some level of regulation in all the states. The extent of price regulation for other commercial property-casualty lines tends to vary inversely with the size of the buyer. The rates for certain types of health insurance may be regulated but the prices of life insurance, annuities and related products are only indirectly regulated through the product approval process.

Insurers' policy forms and products also tend to be closely regulated with the exception of products purchased by large firms. Other aspects of insurers' market activities, e.g., marketing, underwriting, and claims adjustment, generally fall within the area of "market conduct" regulation. A state may impose some specific rules regarding certain practices, such as constraining an insurer's use of certain factors in underwriting or mandating that they offer coverage to all applicants. Beyond this, regulation tends to

[21] Each state has a property-casualty guaranty association and life-health guaranty association. A state's guaranty association covers the claims obligations of an insolvent insurer in that state, regardless of where it is domiciled.

be aimed at enforcing "fair practices" based on regulators' interpretation of what this means. Monitoring and enforcement activities are typically implemented through investigating consumer complaints and market conduct examinations.

Not surprisingly, market regulatory policies and practices are complex and also subject to the greatest criticism by insurers and economists. Further, this is an area where the states' most strongly defend their individual authorities and prerogatives. A number of factors influence a given state's policies, including the cost of risk and its political climate, among many others. Economists tend to have greater confidence than regulators and legislators in the ability of competitive insurance markets to produce efficient outcomes. Perhaps more importantly, political interests and social preferences are often at odds with the outcomes of competitive and efficient insurance markets, such as risk-based prices. This difference in perspectives is fundamental to understanding the reasons for the fierce debate about insurance regulatory policies and the prospects for their reform.

One more point needs to be made. Financial and market regulation are often discussed separately but they are necessarily intertwined. The regulation of an insurer's financial condition and risk has implications for its market practices and vice versa. This is an important consideration in discussing alternative regulatory frameworks and policy reforms.

V. Reforming Insurance Regulation

In this section we review insurance regulatory policy reforms and alternative frameworks separately and jointly. In theory, a given framework, e.g., the current state system or an OFC, could employ good or bad policies. In reality, changes in policies and changes in frameworks are often linked. One reason for this is that a given framework may be more appropriately structured to enforce certain policies and achieve certain regulatory objectives, political considerations aside. A second reason is that proponents of a particular framework typically view it as a vehicle for policy reform in addition to its intrinsic merits. This is an understandable and justifiable perspective as the prospects for policy reforms under the current state system are different than under alternative systems. That said, there is no guarantee that, over the long term, a federal regulator would adhere to "good" policies in the view of the industry or economists. We address these considerations below.

A. Regulatory Policy Reforms

Our review begins with insurance regulatory policy reforms that the industry and/or academic researchers strongly advocate. By necessity, we focus on the most significant reforms and briefly identify others. We provide citations to more extensive analyses of proposed reforms. We discuss regulatory policies leaving the question of the best regulatory framework aside for the moment. Our evaluation of alternative frameworks considers their intrinsic merits as well as the policy changes that might occur with these systems.

1. Solvency Regulation

The approach to overseeing the financial condition and risk of insurance companies should be foremost in any discussion of regulatory policies. This is an area of considerable concern as the current US system is outmoded and lagging behind the evolution of the industry and systems employed or being developed in other jurisdictions, such as the European Union (EU).[22] The states have tended to apply a prescriptive or rules-based approach to regulating insurers' financial condition that is heavily influenced by an accounting perspective. This is reflected in a voluminous set of laws, regulations, rules and other measures that govern insurers' financial structure and actions. Regulators tend to focus on insurers' compliance with these prescriptions rather than the prudence of their management and actions and their overall financial risk. The emphasis on an accounting rather than a financial risk view in US regulation, as well as a prescriptive approach, affects insurers' incentives and ability to manage their financial risk. It also affects their efficiency and ability to compete in international insurance markets.

Unlike the US, many European countries such as the United Kingdom (UK) have employed or are moving towards what might be labeled as a "prudential" or principles-based approach to insurance regulation. In a prudential system, emphasis is placed on insurers' maintaining an adequate "solvency margin" and the competence and judgment of an insurer's management and actions with an insurer's financial risk being the ultimate point of focus for supervisors. This philosophy is embodied in the EU's collective insurance solvency initiatives that set common standards for all EU member countries.[23]

[22] See, for example, Klein and Wang (2007) for an assessment and comparison of US and EU insurance financial regulation.
[23] See Eling, Schmeiser, and Schmit (2007) for a more a detailed review of EU solvency initiatives.

EU regulators tend not to subject insurers to the kind of voluminous and detailed set of rules used in the US. Instead, they maintain closer scrutiny of how insurers are managed and exercise greater discretion in the actions or interventions they may employ to correct practices or problems as they deem necessary. Many EU countries have also more quickly embraced a financial/economic approach to insurer regulation than their US counterparts. This approach tends to allow insurers greater freedom as long as they use that freedom judiciously, do not engage in excessively hazardous ventures or transactions, and ultimately keep their financial risk within reasonable bounds. This more progressive approach to the financial regulation of insurers is embodied in the EU's Solvency II initiative which is scheduled for implementation in 2012-2013.

Virtually every aspect of insurer financial regulation in the US is driven by its prevailing philosophy and approach. All of the standards that insurers are required to meet are stated in terms of accounting values. Hence, insurers' compliance with these standards is assessed by examining their financial statements and other financial reports they are required to submit. Clearly, the filing of financial statements according to a set of accounting principles is an essential part of any financial regulatory system. The concern is that regulators place too much emphasis on these financial statements and the accounting values reported as well as complying with a detailed set of rules. Accounting values may not provide a true picture of an insurer's financial condition and are inadequate for assessing an insurer's financial risk. Further, an insurer can comply (or at least appear to comply) with all of the regulatory rules, yet still assume an excessive level of financial risk.

Two of the most important elements of the US financial regulatory system – risk-based capital (RBC) requirements and solvency monitoring measures – have several limitations which include but are not confined to their reliance on accounting values. RBC requirements are based on a standard formula developed by the NAIC that is both complex and flawed.[24] All of the "charges" used to calculate an insurer's RBC requirement involve the application of selected factors to various accounting values. All but a few companies greatly exceed their RBC requirements which are considerably less stringent than the capital standards set by rating agencies (Klein and Wang, 2007). The label "risk-based" is arguably a misnomer because the US does not employ methods that many experts and the most progressive regulators believe are needed to assess an insurer's financial risk and the adequacy of its capital.

Currently, US insurers are not subject to any requirements to perform internal risk modeling or allowed to use it as an optional approach to demonstrate the adequacy of their capital and financial risk management. US regulatory standards also have not embraced an Enterprise Risk Management (ERM) perspective in requiring insurers to evaluate the full range of risks they face and their interaction. Consequently, regulators do not provide any incentives for insurers to employ internal risk modeling or ERM, although some insurers may still retain internal incentives to undertake these analyses. This, in turn, diminishes insurers' regulatory incentives to better manage and finance their financial risk.

The US has a highly-developed monitoring framework that, arguably, is motivated in part by its relatively low capital requirements. However, these systems are

[24] See e.g., Cummins, Harrington, and Klein (1995), Grace, Harrington and Klein (1998) and Cummins, Grace, and Phillips (1999) for examinations of the NAIC's risk based capital standards and its early warning systems.

static, "ratio-based" tools. They involve no dynamic testing or modeling, which admittedly is difficult to perform using a standard approach but not impossible.[25] Financial examinations also tend to focus on verifying the accuracy of an insurer's financial statement, although regulators have the authority examine all aspects of an insurers' management and operations. Targeted examinations can be called to focus on a certain aspect of an insurer's financial condition or operations but such exams are generally triggered by a review of an insurer's financial statement and not other warning signs. Finally, regulators can access a wide range of information to gain insight into an insurer's true financial condition and risk but the evidence does not indicate that this has become a significant component of the solvency monitoring process.

There is a strong need to upgrade US solvency regulation to what experts would consider to be "best practices." The EU's Solvency II could be used as a template but US regulators need not mimic any particular system to create the best possible system. It is fairly clear that the US needs to move to a more comprehensive approach to financial regulation that employs some form of dynamic modeling and relies on more than financial statements to assess insurers' risk. Dynamic modeling is best performed by each insurer using an internal model subject to regulatory standards, oversight and certification. This is a reasonable requirement for larger insurers but may be problematic for smaller insurers as the EU has found. Smaller insurers could be required to use a standard dynamic model (the EU is developing such a model) which will be less informative than a customized, internal model but better than the current static solvency testing employed by US regulators.

[25] Cummins, Grace and Phillips (1999) demonstrate how this can be done.

US regulators have talked about employing a principles-based approach to solvency oversight but the current system falls far short of this vision. Admittedly, this will be a huge task and challenge as it would involve discarding the voluminous set of rules currently in place with a set of principles and standards that regulators would need to understand, apply and enforce. This would be a "sea-change" in the current regulatory regime and may not occur within the foreseeable future without a regime change or substantial economic pressure.

There are two other aspects of US solvency regulation that warrant at least a brief discussion. The first deals with collateral requirements for foreign reinsurers. In order for a US insurer to claim "accounting credit" for reinsurance recoverables, their reinsurers must be licensed in the US or post collateral equal to their obligations to US insurers. This is an inefficient, costly and excessive policy (see Cummins, 2007). The NAIC has been working on a modified approach that would scale a foreign reinsurers' collateral obligation according to a rating of its financial strength. Cummins (2007) argues that this is a second-best solution that would be unnecessarily cumbersome and advocates the removal of all collateral requirements. Even as a second-best solution, the NAIC proposal has been fiercely opposed by US reinsurers and any reform of the current approach to foreign reinsurers is likely to be protracted and greatly compromised.

The other aspect of US solvency regulation that deserves mention is its system for intervention against financially distressed insurers and managing their insolvencies (termed "receiverships"). Grace, Klein and Phillips (2002) identify a number of problems with the US receivership system and also find evidence of regulators exercising excessive forbearance in dealing with troubled insurers. Each state manages the receiverships of its

domiciliary insurers that become insolvent. Receivership management is highly inefficient and largely opaque to anyone other than the receivers. After the issuance of the Grace, Klein and Phillips (2002) report and other critiques, the NAIC embarked on a tortuous process to reform some aspects of the system. Unfortunately, this effort has been bogged down by a fierce battle between groups with strong vested interests in the current system and other stakeholders who advocate significant reforms. It is unclear when and how this battle will be resolved, but the outcome is likely to fall short of what many external experts and stakeholders believe is needed.

We should note that the industry has not been pushing for a major overhaul of the US financial regulatory system, although it has advocated some specific reforms as discussed above. Some (possibly many) US insurers might view an EU-type of system as superior, but they are likely skeptical that US regulators would substitute its extensive set of rules and reporting requirements with a more efficient and effective system. Ultimately, international pressures may be the primary catalyst for substantive reform of the US system. Of course, a federal regulator might embrace a new paradigm and a regime change would present an opportunity for significant reforms, but there is no guarantee that this would occur without significant economic pressure.

2. Market Regulation

The industry push for policy reforms are aimed primarily at market regulation. As discussed above, the scope of market regulation is quite broad and, hence, offers a number of tempting targets for discussion. We identify and briefly review the most significant reforms and refer the reader to analyses that examine market regulatory policies in greater depth and detail.

The most prominent and criticized policy is rate regulation. The extent and stringency of rate regulation varies significantly by line and by state. The lines subject to the greatest rate regulation are personal auto, homeowners, and workers' compensation insurance. The reality is that in most states and markets, at a given point in time, regulators do not attempt to impose severe price constraints. The problem arises when strong cost pressures compel insurers to raise their prices and regulators resist market forces in an ill-fated attempt to ease the impact on consumers. Inevitably, severe market distortions occur and regulators are forced to switch course when a major crisis develops.

The argument for rate deregulation is fairly straight-forward. One would expect that prices in competitive insurance markets would be "actuarially-fair" and not excessive. Also, competition should drive insurers to be efficient and prices should gravitate to the lowest possible level necessary to cover the cost of an efficient insurer, including its cost of capital or a "fair" profit. If one accepts the notion that competitive prices are desirable and insurers will charge such prices in the absence of government intervention, then there is no need for rate regulation if insurance markets are competitive. The empirical research overwhelmingly confirms both the competitive nature of insurance markets and the lack of benefits from rate regulation as we discussed in Section II.[26] Requiring or authorizing regulators to regulate rates invites political pressure and interference that can lead to the dismal scenario described above.

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[26] For analyses of competition in insurance markets see Klein (2005), Cummins and Weiss (1991) and Grace and Klein (2007). One should note that a regulated policy may be significantly different than an unregulated policy. Thus, comparing regulated and unregulated polices over time might be somewhat misleading. However, if regulation imposes costs, but provides no benefits (in terms of lower prices), then why undertake the costly intervention? Three states have recently deregulated: South Carolina, New Jersey, and Massachusetts. In the first two states we have seen greater participation in the market by new insurers and more innovation in insurance contracts. In Massachusetts, we are just now seeing new rate filing as well as new firms showing interest in providing insurance to Massachusetts customers. See Jeffrey Kranser, Progressive Joins Massachusetts Insurance Auto Market, Boston globe (February 26, 2008) found at

A more obscure aspect of insurance, except when major problems develop, is the management of residual market mechanisms (RMMs). These mechanisms can take different forms but their stated intention is to provide a source of insurance coverage for buyers who cannot obtain coverage from an insurer in what is called the "voluntary" market. They are commonly found in personal auto insurance and workers' compensation and in the majority of states for homeowners insurance. It could be argued that these mechanisms serve a legitimate purpose and may be unavoidable in the presence of compulsory insurance requirements. Further, these mechanisms generally remain small in states where insurers are allowed to charge risk-based prices and they are managed to be truly "markets of last resort" with adequate rates and stringent eligibility requirements.

However, significant problems can arise when the voluntary market is subject to severe regulatory constraints and residual market mechanisms are mismanaged. When this happens, RMMs can grow rapidly and incur substantial deficits that are assessed back to voluntary market insureds. This can lead to the infamous "downward spiral" in which the voluntary market begins to implode as the RMM explodes.[27] Hence, good rate regulatory policies – preferably price deregulation – should be accompanied by the proper design and administration of residual market mechanisms. This requires that RMMs charge risk-based rates, enforce strict eligibility requirements, and avoid funding shortfalls.

A third aspect of market regulation that receives considerable scrutiny is the area of policy forms and insurer's products. In a competitive market, we would expect most

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http://www.boston.com/business/personalfinance/articles/2008/02/26/progressive_joins_mass_insurance_market/.

[27] This situation has occurred in Florida homeowners insurance where the state's property insurance RRM – the Citizens Property Insurance Corporation – has become the largest writer of homeowners insurance (Klein, 2007).

insurers to develop and offer legitimate insurance products that would serve consumers' needs and preferences according to the kinds and extent of coverage they are willing to pay for. At the same time, because of consumers' difficulty in understanding insurance policy provisions, some insurers might seek to exploit consumer ignorance by selling them products that contain substantial gaps that are not transparent to consumers.

Hence, reforming product regulation is a more complicated proposition than deregulating prices. There are two elements of product regulation that require particular attention. The first is mandated coverages or prohibitions on the exclusions that may be offered in a policy (Harrington, 2006). The second aspect is the arduous review process that insurers must undergo to get products approved and introduced in the market. While the industry might support broad deregulation of insurance products, regulatory experts might understandably differ on how far such deregulation should go. This will undoubtedly be an area of considerable discussion in considering any set of proposed reforms.

Another complex area is the scope of activities encompassed within the underwriting function. These include risk assessment, risk classification, accepting or rejecting insurance applications, non-renewal or cancellation of existing policies, determining the premium that will be charged (for a specific insured), product assignment and special terms and conditions attached to issuing a policy. Regulatory rules and interference with underwriting activities varies by state and line. For the most part, regulators tend to give insurers fairly wide discretion in underwriting risks but there are some notable exceptions that warrant attention. They include: 1) mandatory offer

requirements; 2) restrictions on the use of certain factors in underwriting and pricing; and 3) interference with an insurer's efforts to restructure its portfolio of exposures.

Some states impose mandatory offer requirements, also called "take-all-comers" laws, which compel insurers to accept any applicant as long as they meet minimal insurability requirements. These requirements are often imposed in auto and home insurance which are viewed as "essential" insurance coverages and, hence, justify such requirements. These requirements undermine an insurer's need to achieve a balanced portfolio of risks and avoid adverse selection. They are especially problematic when regulators constrain insurers' rate structures and the coupling of a mandatory offer requirement and rating constraints is not a sheer coincidence.

A related problem is created by prohibitions of or limitations on the underwriting and pricing factors used by insurers. Clearly, there are some characteristics such as race that go beyond the pale of what is appropriate. The problem lies with constraining insurers' use of factors that are statistically correlated with the risk of loss and their use does not violate societal taboos. One example is the use of credit scores in auto and home insurance. There is considerable statistical evidence that credit scores are strongly correlated with risk but their use has been highly controversial. Critics contend that there is not a causal link between a person's credit score and their risk of filing a claim and credit scores give false indications for some insureds. These critics also argue that credit scores also lead to implicit unfair discrimination because low-income and minority consumers are more likely to have lower credit scores because of circumstances they cannot control.

However, one could make similar observations about many of the underwriting and pricing factors that insurers use in auto and home insurance. The fundamental issue is whether insurers should be allowed to use factors that improve the overall accuracy of their underwriting and pricing or whether they should be allowed to only use factors that are unlikely to give an incorrect indication of a given insured's risk level. Risk classification is inherently imperfect and competition should drive insurers to use the best factors because their failure to do so will expose them to adverse selection and "cherry-picking" by their competitors. This issue is also likely to be contentious in any effort to reform regulatory policies and it would be desirable to develop a set of principles that would guide regulation in this area.

The final item we mention is the attempt by regulators and legislators to prevent or hamper insurers in restructuring their portfolios of exposures. The best and most current example of this policy is Florida's attempt to constrain insurers' retrenchment from high-risk coastal areas. Florida officials are seeking to preserve the availability of insurance but retrenching insurers perceive the need to reduce what they consider to be excessive concentrations of high-risk exposures that greatly increase their financial vulnerability to hurricane losses and are unsustainable from a business perspective. Ultimately, these kinds of government constraints are doomed to fail and impede the readjustment of insurance markets to new, sustainable equilibriums. As insurers with excessive concentrations of coastal exposures retrench, this creates opportunities for other insurers that are well-positioned to fill the gap if they are allowed to charge adequate rates and take other prudent steps to manage their financial risk. This may a difficult pill to swallow for politicians but it is the only viable solution without a federal

bailout, e.g., a federal catastrophe insurance/reinsurance program. It appears that coastal politicians are counting heavily on such a bailout but they may be disappointed.

B. Alternative Frameworks

Debate continues over whether full oversight of the industry should be transferred to the federal government. Various proposals for some form of federal regulation (or greater federal involvement in state regulation) have been vetted over the years. The concept that is currently receiving the greatest attention and regulatory support is the establishment of an Optional Federal Charter that would allow an insurer to choose to be federally regulated and exempt from state regulation. Another concept which has been proposed but has received less attention is the enactment of federal standards for state regulation that would impose greater uniformity on the current system. We discuss these and other possible frameworks below.

1. Status Quo

A good place to start is the current system of state regulation. To many observers, some form of federal insurance regulation may be inevitable but the states and some interest groups would strongly disagree. Regardless of what observers think, opponents of federal regulation wield considerable political power and prospects for any radical changes in the near future are questionable. What might we expect to happen if the states continue to retain their regulatory authority, at least over the near term?

As discussed earlier, both industry pressures and the threat of federal intervention have compelled the states to embark on a set of ambitious set of policy and institutional reforms. The stated intent of these reforms is to streamline, harmonize and rationalize the

current system of state regulation while preserving certain state prerogatives. In essence, the states are seeking to reduce as much of the inefficiency that has been associated with the state-based framework as politically and logistically possible.

This is an important qualification. Fundamentally, if the states wish to retain most of their discretion in how they regulate insurers' market practices, then there is a limit to how far harmonization can go. For example, if a state insists on retaining rate regulation, mandated coverages, and prohibitions on certain underwriting factors, there is no force other than the federal government or market pressures to compel it to do otherwise. Further, the NAIC's centralized systems for filing rates and policy forms, agent licensing, and other processes must accommodate differing state requirements and regulatory approvals and compliance are determined by each state, not the NAIC. Finally, the policy reforms supported by the majority of states fall far short of what the industry and many experts advocate.

There are some positive aspects of this picture. One is that the states have made substantial strides even if they fall short of what could be achieved under an alternative framework. A second observation is that the threat of federal intervention has tended to push the states in the right direction. Thirdly, while state inertia may thwart or delay beneficial policy reforms it also can discourage nationwide shifts in the opposite direction. In other words, it is better to fight excessive price regulation in a few states than to have a federal regulator establish such a policy in all states. Fourth, state regulators are close to the consumers they are sworn to protect and this may offer some benefits to the industry as well as consumers.

Hence, the current system, while inherently inefficient and still driven by local political winds, is still evolving and improving. Ironically, the strong push for federal regulation plays a significant role in driving this evolution. Like it or not, this is the system that insurers may have to live with for some time to come. In such a scenario, regulatory reform is likely to incur incrementally both at the state and federal level.

2. Federal Standards

One approach to increasing the federal role in insurance would involve creating federal standards for state regulation. This concept is embodied in a draft legislative proposal released in 2004 - the State Modernization and Regulatory Transparency (SMART) Act – by Representatives Michael Oxley (R-OH) and Richard Baker (R-LA). The proposed legislation would establish minimum standards that would govern various aspects of state insurance regulation. Federal rules would preempt state regulations that fail to comply with the minimum standards after specified time periods.

The areas of insurance regulation encompassed by the SMART Act include, but not limited to:

- Market conduct;
- Rates and policy forms;
- Insurer and produce licensing;
- Surplus lines;
- Reinsurance;
- Financial surveillance; and
- Receiverships.

Essentially, all lines of insurance and industry sectors would be covered by the Act. A State-National Insurance Coordination Partnership would be charged with determining state compliance with the federal standards and resolving disputes among government agencies.

This proposal has two principal objectives. One, it would compel the states to achieve a level of regulatory uniformity that they might not otherwise achieve. Two, it would dictate insurance regulatory policies in a number of areas. The dual nature of the proposal – framework reform and policy reform – is also characteristic of other proposals for federalizing insurance regulation.

Some might view the SMART concept as less intrusive and ambitious than other proposals that would establish a federal regulator, although it is still opposed by the states and consumer groups.[28] Under SMART, the states would still have the responsibility for insurance and regulatory oversight and enforcement, as well as retain some discretion in regulatory policy within the limits of the federal standards. As Harrington (2006) observes, SMART would avoid the establishment of a federal regulator and its associated bureaucracy. Further, it could avoid significant policy swings that would undermine market efficiency and harm consumers. The term "could" is an important qualifier as the enactment of the SMART Act would not preclude subsequent congressional changes to its minimum standards.

At the same time, Harrington identifies a number of potential disadvantages to SMART. From a framework perspective, one of the principal concerns is that SMART could prove to be an administrative, monitoring and enforcement nightmare. Some states

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[28] See Harrington (2006) for a comparative review of different options and proposals for federalizing insurance regulation.

might seek to circumvent the standards and there would be the prospect of protracted and costly disputes regarding states' compliance with the standards. SMART could be simplified and its scope narrowed, but this would also undermine its objectives of greater uniformity and policy reform. This reflects the fundamental tension between uniformity and the states' prerogative to regulate insurance as they see fit.

The policy changes contemplated under SMART are broad in scope and, arguably, are its principal objective. The thrust of these reforms is to substantially deregulate many areas of insurance and lessen regulatory constraints in others. The states and consumer groups oppose a number of these changes, arguing that they gut essential consumer protections. The proposed reforms are outlined at a relatively high level in the draft document. If a legislative version was introduced in the Congress, it would likely be much more detailed and specific and subject to intensive discussion and modification. At this time, it appears unlikely that any version of the SMART Act will be introduced as the industry is placing its bets on OFC legislation. Still, the concepts and policies embodied in SMART could emerge in an OFC bill as it proceeds through its legislative gauntlet.

3. Optional Federal Charter

The vehicle for the Optional Federal Charter (OFC) approach is the National Insurance Act (NIA) – S. 40 – introduced on May 24, 2007 by Senators John Sununu (R-NH) and Tim Johnson (D-SD).[29] While there are many details that may or may not be in

[29] SB 2106 109th Congress.

a final bill enacted by Congress, there are a number of important provisions that are likely to be present in any legislation that is enacted.[30]

The NIA would set up the Office of National Insurance (ONI) regulator within the Department of the Treasury. This regulator would look very much like the Office of the Comptroller of the Currency (OCC), the agency that regulates national banks operating in the US. In fact, the entire proposed federal insurance regulatory system is modeled on the OCC. Like the OCC, the ONI's functions would be funded by an assessment on the insurers it regulates.

The NIA permits both life and non-life companies to apply to the ONI for a charter and license to sell particular products in all states. It further permits the ONI to regulate the solvency and market conduct of insurers within its jurisdiction. Additionally, it authorizes the Commissioner of National Insurance to establish a comprehensive insolvency resolution scheme which includes the state guaranty associations (funds) which meet minimum qualifications. Thus, the ONI would oversee solvency oversight, policy forms, other aspects of market conduct, and insurer insolvencies. It would not regulate prices (except that prices and reserves have to be based upon sound actuarial principals) or underwriting standards.[31] Further, assuming that the states' solvency guarantee system is adequate, a national insurer would participate in the state solvency guaranty plans.[32] If a state plan does not qualify, there would be a federal plan that would cover these insolvent OFC insurers' obligations in the state.

[30] Scott (2008) and Brown (2008) examine the merits of an insurance OFC and federalizing insurance regulation.

[31] Note that states also do not regulate life insurance prices per se. The states only regulate prices indirectly in their review and approval of life policy forms which includes consideration of the relationship between the premiums that would be charged and the benefits that would be paid.

[32] We presume that, under this arrangement, the state guaranty association would function essentially as it does under the current state system. An insolvent insurer's claims obligations in a given state would be

States would not be able to discriminate against National Insurers (those companies receiving a national charter) or National Insurance Agencies (those agencies with a national license). States would still be permitted to tax insurers under current tax law - again with the qualification that no national insurer or national agency would be taxed differently than insurers domiciled in a state. This would preserve both state premium taxes and the special aspects of their retaliatory taxes.

National insurers or agencies would also be allowed, under the NIA, to choose their state of domicile which could be different than the state where the company has its headquarters if the company so desires. In addition, the NIA would permit insurers to choose the law under which their insurance contracts are to be interpreted. Finally, the NIA would subject the industry to the antitrust provisions specifically exempted under the MFA. The major exception to the antitrust exemption repeal would be that insurers would still be able to share information about losses or claim payments.[33] Finally, the NIA allows lawsuits in a federal court if a state attempted to interfere with the operation of a national insurer or agency.

Theoretically, federal regulation would offer structural efficiencies over the current state regulatory system. Economies of scale could be achieved by consolidating insurance regulatory functions in one central agency. Presumably, the coordination and communication problems faced by state insurance departments would also disappear but such problems can arise even within a single federal agency, albeit to a lesser extent.

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covered by that state's guaranty association. Assessments to cover the guaranty association's claim payments would be allocated to insurers in the state according to the amount of life insurance premiums they write in the state.

[33] This is more pertinent to non-life insurance than life insurers. Life insurers do not use statistical agents to compile industry data on the amount of benefits they pay, although this information is reported in their public financial statements filed with regulators and others. Life insurers use mortality tables published by the NAIC as a reference to assist them in pricing life insurance policies and annuities.

Insurers and producers would be subject to one uniform set of laws and regulations nationwide, reducing barriers to interstate operations and facilitating greater competition. This should significantly reduce the regulatory costs borne by insurers (and ultimately their policyholders) in dealing with 56 regulatory jurisdictions. Overall, a fairly strong case can be made that a federal system, properly designed and administered, would offer the most efficient and effective framework for regulating insurance.

Proponents of an OFC also are hoping that it would result in significant policy reforms. Most important, rate regulation would be eliminated for OFC-regulated insurers – a major concern of property-casualty insurers. OFC policies in other areas are more difficult to predict, but additional reforms are possible. For example, the standards for and regulation of insurance products could be rationalized and unnecessary and inefficient constraints could be avoided. A federal regulator could also establish and enforce more reasonable and efficient oversight of other aspects of insurers' market practices. Finally, a more progressive principles-based approach could be employed in the financial regulation of insurers.

However, there is no assurance that the federal government would establish and sustain a more reasonable and efficient set of policies than the states. There are a number of instances where the Congress has intervened and required the states to impose additional regulatory constraints on insurers in certain areas such as health insurance. For example, during the Clinton Administration, the Department of Housing and Urban Development sought to extend Community Reinvestment Act (CRA) requirements to homeowners insurers. Some members of Congress are currently calling for tighter regulation of property insurance in hurricane-prone areas. Consumer advocates and

economists can debate whether such policies would be welfare-enhancing, but the federal government is not immune from interest group pressures and excessive and unsound regulatory actions.

Despite a strong push from many segments of the insurance industry for an OFC, the states and certain industry groups – independent insurance agents and state/regional insurance companies – present a formidable opposing force. The current Administration and some members of Congress have expressed their support for the OFC but this has not been sufficient to release OFC legislation from its political tar pit. At present, attention is focused on the upcoming elections and more pressing issues, such as the condition of the economy and the "credit crisis."

Hence, the prospects for moving the OFC legislation will need to be reassessed when a new administration and Congress assume their positions. There is a strong likelihood that they will be preoccupied with many pressing issues and it is unclear how OFC legislation (or something akin to it) will fare in this environment. Indeed, new issues have emerged about the need for strengthening federal regulation of banks and financial markets. The Treasury Department's proposal for revamping the regulation of financial institutions includes a component for federal regulation of insurance companies.[34] Hence, insurance is being drawn into a broader reconsideration of financial regulation that could aid or hamper OFC efforts.

This depiction of the political-economic climate surrounding insurance seems to be consistent with the record of interest group lobbying. Such groups have achieved some success in getting the federal government to intervene in or supersede state regulation in specific areas. For example, Congress has enabled the creation of risk retention groups

[34] See U.S. Treasury Department (2008).

and enacted ERISA; actions from which it achieved some political gains without having the federal government take on costly administrative and regulatory responsibilities that could possibly fail.[35] As noted above, there are a number of other areas where the federal government has selectively superseded state regulatory authority over insurance, including health insurance, Medicare supplement insurance, crop insurance, and flood insurance. There are additional legislative efforts to curtail state constraints on surplus lines insurance and reinsurance. These kinds of selective and "low-cost" interventions (low cost to politicians) will likely continue even if OFC legislation continues to languish waiting for more favorable political winds.

4. Other Schemes

There are a number of other potential regulatory frameworks that have been discussed or might be considered. One such framework would allow an insurer to choose one state as its regulator (Harrington, 2006; Butler and Ribstein, 2008). There are several potential advantages to such an approach. One is that it an insurer would be subject to a single regulator and one set of rules. A second advantage is that it would make use of the existing state insurance regulatory agencies and avoid the need for creating a new federal bureaucracy. A third advantage envisioned by those favoring such an approach is that it would promote healthy regulatory competition among the states. The states would have an incentive to establish good regulatory systems to attract or retain insurers within their jurisdictions.

[35] The Risk Retention Act allows risk retention groups to offer insurance in certain areas, e.g., liability coverage, under fewer regulatory restrictions. Firms buying such coverage strongly lobbied for the legislation. Similarly, large firms buying group health insurance lobbied for ERISA which exempts qualifying employer plans from state regulatory oversight.

This kind of approach shares some similarities with the current rules governing Risk Retention Groups. The concern that some might raise would be that it would induce a "race to the bottom" in the sense that states would be induced to go too far in creating "lax" regulatory systems to attract insurers. Grace and Klein (2007) offer counter-arguments to this concern. In essence, they argue that insurers would be most attracted to "good" regulators as this would enhance their reputation and ultimately contribute to firm value. They point to the banking industry where regulatory competition has tended to lead to better regulation as well as benefits to consumers. Still, one might want to insert some safeguards so that "low-quality" insurers would not abuse such a system. Actually, rating agencies could take regulatory quality into account in their assessments of insurers. Unfortunately, not all insurers are rated and consumers (and their agents) do not always pay attention to insurers' ratings when they buy insurance. A single state regulator would also need to be able to address market conduct issues wherever its insurers operated.

Another system that has been discussed would delegate solvency regulation to the federal government and market regulation to the states. The appeal of this kind of system is that a single federal regulator might be best positioned to oversee the financial condition and risk of multistate insurers and some might believe that the states are best positioned to deal with other consumer protection issues within their respective jurisdictions. Further, there is some precedent for this kind of federal-state system in the financial services industry as well as certain other countries, e.g., Canada and Australia.

However, there are some potential concerns with this kind of system. One is that state regulatory constraints and actions could have implications for the financial condition of an insurer. Further, it would not address most of the complaints about the

current system that have more to deal with market regulation than financial regulation. Hence, while this model has some attributes, it is unlikely to satisfy proponents of federal regulation nor induce the states drop their opposition to a greater federal role in insurance regulation.

Our discussion has omitted other proposals that have been offered. These include the Insurance Consumer Protection Act, a mandatory federal charter for insurance companies, and a National Insurance Office. There may be others we have failed to mention. While these other proposals are not in forefront of current discussions, some of their elements could appear in future initiatives to reform the framework for insurance regulation.

VI. Anti-Trust Policy and the McCarran Ferguson Act

A. Introduction

As mentioned above, the McCarran-Ferguson Act[36] (MFA) was passed in 1945 following the Supreme Court's 1944 decision in *Southeastern Underwriters.*[37] In that case the Court held that insurance, which had been thought to be immune from federal regulation, was now subject to antitrust and, possibly, other federal laws. The MFA provided a Commerce Clause exemption to the insurance industry to allow it to operate under the regulatory authority of the states and not the federal antitrust laws.

In considering industry antitrust law it is helpful to look at some simple statistics describing how the insurance industry of 1945 compares to that of 2006. The industry has

[36] 15 U.S.C. §§ 1011-1015.
[37] 322 U.S. 533 (1944).

changed significantly which has implications for the modification and application of antitrust laws. Table VI.1 shows premium volume for companies in 1945 in 2006 dollars. There has been a twenty-five fold increase in property-casualty insurance premiums and a 10-fold increase in life and annuity premiums. In contrast, the US population has just more than doubled over the same time period. Automobiles per capita have increased about 2.5 times. The number of property-liability companies has increased about 4.5 times and the number of life insurers has increased about 3.5 times.[38] Life industry assets have increased about 10 times while the assets held by the property-liability industry have increased over 130 times. As a result, the ratio of assets of the property-liability industry to total industry assets has grown from about 2.1 percent to 30.7 percent. This suggests that the property-liability risks have become more important over time. Overall, the sale of life and non-life insurance products and their "coverage" of US households and firms have greatly increased.

Table VI.2 shows the further extension of insurance transactions across state borders. Insurance is now predominately a large multistate industry with a high percentage of premiums written by companies operating in over one-third of the states. The NAIC defines a nationally-significant company (in part) by the number of states in which it operates. Table V.2 shows the premium volume for the nationally-significant companies (i.e., those with licenses in 17 or more states). The data is aggregated to the group level so that any companies with multiple subsidiaries are aggregated. For the life business, almost all premiums and annuity considerations come from nationally-

[38] Many of the property-liability companies are captive insures which means they were set up to cover the property or liability risks of general corporations. They do not operate to sell to the general public.

significant companies. For the property-liability industry, approximately 80 percent of its premiums come from the nationally-significant companies.

The industry has grown dramatically in a number of dimensions since the 1940s and has many more ties to the national and international insurance markets. Insurance rating or advisory organizations no longer issue uniform rate structures which insurers are required to follow. In fact, it is possible that the entire rationale for the industry's antitrust exemption provided by the MFA no longer exists. Insures have a much better understanding of how to price insurance products and markets are more competitive and dynamic. In fact, other than the fact that repeal of the MFA will create legal uncertainty about industry practices, there do not seem to be many reasons to object to repeal.

In his section we review the historical background for the enactment of the exemption as well as address the rationales for repeal and the status quo. In addition, we identify potential winners and losers from repeal. We offer some concluding comments at the end.

A. More History

The insurance industry has had a love-hate relationship with state regulation over the course of the past two centuries. Earlier, we provided a brief historical summary of state insurance regulation but left some important historical incidents for this section. One noteworthy observation is that the industry's current push for federal regulation is not the first. The first foray into possible federal regulation occurred when the industry attempted to obtain legislation comparable to what banks received under the National Bank Act of 1864. However, it was not able to convince Congress to pre-empt state regulation.

Just after the Civil War, the State of Virginia brought a lawsuit against an unlicensed out-of-state insurance agent working in Virginia. State law required all agents to obtain a license, but the agent claimed the Constitution's Commerce Clause prohibited the state's interference in interstate commerce. In *Paul v. Virginia*[39] the Supreme Court, concluded in a quaint, legalistic, and to the modern ear, illogical way that insurance was a local transaction and not subject to Congress's interstate commerce power.[40]

After the Civil War, parts of the industry such as fire insurance grew in major urban areas. Competition for business was strong. Further, there were few real entry barriers as there was merely a minimal capital requirement to start an insurer. In addition, there was no regulation (or science) regarding the proper determination of insurance prices. Thus, insurers were able to price in any manner they desired. As long as there were no major fires, the industry appeared profitable attracting new entrants and even lower prices. However, after a series of severe conflagrations in major cities, such as those in Chicago (1871) and Boston (1872), many insurers went bankrupt (Kimball and Boyce, 1958; Joskow, 1973). Insurers were able to cope with the occasional house fire, but not the catastrophic fires where most of the company's insured properties were damaged or destroyed. As a result, insurers were encouraged to join rating bureaus to raise prices that would strengthen their financial capacity and handle major fires. The rating bureaus were often multistate affairs which had the possibility of cartelizing the industry, at least at a regional level.

At the same time, as a result of the growth of the industrial trusts, Congress also passed the Sherman Antitrust Act in 1890 and later in 1914, the Federal Trade Act which

[39] *Paul v. Virginia*, 8 Wall. (75 U.S.) 168 (1868).
[40] For an excellent history of early insurance regulation see Day (1970).

prohibited a number of activities - primarily attempts to monopolize and conspiracies in restraint of trade. However, because of *Paul v. Virginia*, it was generally presumed that these laws did not apply to the insurance industry.

The industry was not always satisfied with state regulation during this period. For example, the regulators in New York discovered significant abuses in the corporate governance of three of the most important life insurers in the US.[41] As a result of the increased level of regulatory scrutiny in New York and other states, there was an unsuccessful attempt in the late 19th century and again in the early part of the 20th century to gain Congressional interest in some federal oversight that was likely motivated to avoid stricter state regulation (Kimball and Boyce, 1958; Day, 1970). However, due to President Roosevelt's election and the growth of the Supreme Court's reinvigorated commerce power jurisprudence, it appears that the industry's infatuation with the notion of federal regulation was replaced by the fear that federal regulators would be "tougher" than state regulators. This was, in part, due to the New Dealers' reputation of being intrusive administrators (see, for example, Goble, 1941).

The MFA was passed in 1945 in direct response to the Supreme Court's 1944 decision in *Southeastern Underwriters Association of America v. US.*[42] The Court held that the insurance industry was, in fact, subject to the provisions of the Commerce Clause expressly overturning its previous decision in *Paul v. Virginia*.

Southeastern Underwriters was a rate setting board ostensibly established to ensure adequate rates for solvency purposes. Due to the expected losses from the catastrophic risk of city-wide fires which could bankrupt significant numbers of insurers,

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[41] See e.g. Ransom and Sutch (1987) for an historical review of the economics of the life insurance industry and the investigation which became known as the Armstrong Commission.
[42] 322 U.S. 533 (1944).

the industry set minimum prices to prevent insolvency. However, the State of Missouri believed that the rate setting activities undertaken by Southeastern Underwriters were engaging in illegal price fixing in restraint of trade. Missouri's Attorney General unsuccessfully attempted to prosecute Southeastern Underwriters for price fixing and asked the Department of Justice (DOJ) for assistance.[43] The DOJ took the case and made the legal argument that the rate setting boards were operating in violation of the Sherman Act's prohibition of price fixing.

The MFA does three things to address the perceived consequences of the Supreme Court's ruling in the *Southeastern Underwriters* case. First, under the MFA the federal antitrust laws do not apply to the "business of insurance" as long as the states regulate insurance. This means that if a state regulates the industry, then the antitrust laws cannot be used against the industry. What is interesting about this portion of the Act is that the meanings of the terms "business of insurance" and the "regulation" was left to legal interpretation through litigation.

The idea behind the Act is that Congress would defer to states to regulate and tax insurance companies, but if they failed to do so, then the antitrust laws would apply. However, there were a number of cases that tested the scope of the business of insurance exemption. In a relatively recent case *Union Labor Life Ins. Co. v. Pireno*[44], for example, the Court used three criteria relevant to determine whether an insurer's conduct is consistent with the business of insurance exemption: "[F]irst, whether the practice has the

[43] Missouri's problems at the time were interesting. In 1922, the insurance commissioner ordered a 10 percent reduction of fire insurance rates. The industry response was a joint rate increase that raised rates 16 percent. After 25 years of litigation and the bribery of two Insurance Commissioners, the Missouri insurance department was able to "win" the case. However, the Missouri Attorney General was not satisfied with the outcome, especially the public corruption charges. This is what led to the attorney general to seek assistance from the Department of Justice. See, for example, Note (1951).

[44] 458 U.S. 119 (1982)

effect of transferring or spreading a policyholder's risk; second, whether the practice is an integral part of the policy relationship between the insurer and the insured; and third, whether the practice is limited to entities within the insurance industry."[45] While not definitive, the GAO (2005) undertook a review of the litigation regarding the business of insurance definition. It concluded that:

> Courts tend to find that activities among insurers involving cooperative ratemaking and related functions constitute the business of insurance. Insurers may enter into agreements or arrangements that do not involve such matters, but the more the arrangements involve functions that are not unique to the insurance business, or whose primary impact is not on the insurance market, the less likely courts are to apply the exemption. (GAO (2005) at 4).

This is a narrow reading of the term "business of insurance" than others that have been offered. For example, agreements between insurers and pharmacies are not within the business of insurance although the insurer is arguably making the agreements in order to provide lower premiums prices.[46] This is because the pharmacies are not insurers.

Second, the GAO concluded that:

> Courts tend to find that activities between insurers and agents involving the terms of their contracts or the termination of their relationships constitute the business of insurance, provided that the activities are closely linked to the insurer/insured relationship and involve the agent's insurance dealings. (GAO (2005) at 5).

This implies that agreements between insurers and their agents are the business of insurance, but if there was an agent who sold insurance and the insurers non-insurance

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[45] *id*. at 129.

[46] The court in other cases said that the business of insurance exemption is not an exemption for the business of insurance companies, but a more narrow activity focus. See, for example., *Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205 (1979).

services (i.e. banking securities), any dispute about these other services would not be the business of insurance.

Third, the GAO found that:

> Courts tend to find that activities involving the relationship between insurer and insured constitute the business of insurance. If the activity does not involve risk-spreading, however, or if its primary impact on competition is not in the insurance industry, courts are less likely to apply the exemption. (GAO (2005) at 5).

Thus insurers could require certain ties between products. The classic example is that one must be a member of AARP to obtain AARP-related insurance products produced by a third party insurer. However, if an insurer tried to tie insurance to the purchase of a car, it might be outside the business of insurance exemption. Thus, the GAO concluded that the business of insurance, like most antitrust exemptions, should be interpreted narrowly.

Most of the modern discussion of the antitrust exemption concerns insures' ability to share data and allow "advisory organizations" to analyze these data to develop and file "indicated loss costs" for certain lines of insurance.[47] The data shared are loss related and are provided to insurers to assist them in developing accurate rates.[48] Pooled industry data can be more reliable and actuarially credible than individual company data, especially for smaller insurers. The larger the volume of business an insurer writes, the

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[47] Almost universally, any discussion of the repeal of the MFA includes a safe harbor provision for the sharing of data. See e.g. ABA, Section on Antitrust Law, *Comments to the Antitrust Modernization Commission*, found at http://www.abanet.org/antitrust/at-comments/2006/04-06/Com-AMC-McCarranFerguson.pdf. "Indicated loss costs" refer to the expected losses (i.e., claims costs) for certain lines of business in each state. This information is provided in manuals or circulars which include factors that can be used to calculate the expected loss cost for a given exposure according to its characteristics.

[48] The most sophisticated and useful compilations include premium, loss and exposure information organized by various rating characteristics that are essential to determining the expected loss cost for a given exposure (e.g., a house or auto insured for one year). For example, in homeowners insurance, these rating characteristics would include the location of a home and its type of construction, among many others.

more it can rely on its own data for pricing. Medium-sized insurers may use a combination of both their own and industry data and the largest insurers may rely solely on their own data. Ultimately, the compilation and dissemination of industry loss data can facilitate competition and more efficient markets. Information is the most important resource in the insurance industry and data pooling reduces entry barriers and offers other operational efficiencies.[49].

This type of data sharing has been facilitated by private entities known collectively as advisory or statistical agents. Statistical agents only collect and disseminate data and generally perform minimal processing and analysis of the data they collect. Advisory organizations not only collect data but also perform more extensive analysis and develop indicated loss costs. The two largest advisory organizations are the Insurance Services Office (ISO) and the National Council on Compensation Insurance (NCCI). ISO collects member premium, exposure and loss data, aggregates this information, and provides indicated loss costs for various property-casualty insurance lines. The NCCI undertakes the same type of activities for workers' compensation insurance. Both organizations file indicated loss costs with regulators in most states that do not include provisions for expenses and profits. When these filings are approved by regulators, individual insurers may use these loss costs, with or without modification, in filing their specific rates that will include provisions for expenses and profits.[50]

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[49] Coincidentally, regulators also access and use this information in performing their functions. Hence, it has been more often the case that regulators and not insurers have advocated more extensive data reporting.
[50] In the early 1990s, ISO voluntarily decided to no longer provide advisory rates to its subscribers. Instead it provides indicated loss costs, that do not include expense and profit provision, which a subscriber could then use in developing its own rates. The ISO undertook this change as to avoid falling outside the limited antitrust exemption under the MFA. The US Department of Justice summarized its understanding of what ISO purported to do and decided it would offer no challenges to its activities, but reserved the right to do so in the future if circumstances warranted. See Letter dated January 25, 1994 from Assistant US. Attorney General, Anne Bingaman to Mr. Joel Cohen acting on behalf of ISO. Found at

The second question the MFA addresses is the level of regulation which would prohibit the enforcement of the antitrust acts against the insurance industry. One could properly make the argument that if a state had no regulation, then the antitrust laws would apply to the insurance industry's practices within the state. However, what if it had regulation, but it was not adequate?

The courts do not inquire about the adequacy of state regulation directly. Essentially they have held that if an activity is regulated by state law then the in the insurer is subject to general regulatory standards. Further, the quality of the regulatory apparatus or how regulations are enforced is not part of the calculus as to whether an exception is granted.[51]

Finally, the third part of the Act states that federal anti-trust laws apply deals with cases of boycott, coercion, and intimidation. In *Hartford Fire Insurance Company v. California*[52] the issue of boycott was examined by the Supreme Court. In this case a number of state attorneys general and private parties complained that ISO and a set of insurers conspired to change a standard insurance contract form. In addition, it was alleged that reinsurance companies participated in the conspiracy by saying that they would not supply reinsurance to any company unless the company used the new contract. Hence, a boycott was alleged to effectuate the use of the new contract.[53] While the court

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http://www.usdoj.gov/atr/public/busreview/211724.htm. The NCCI came to a similar decision shortly thereafter.

[51] There appears to be little discussion of this question. See e.g. *AFL-CIO v. Insurance Rating Board*, 451 F.2d 1178 (6th Cir. 1971), cert. denied, 409 U.S. 917 (1972). The court held that a state regulates the business of insurance within the meaning of the MFA when a state statute allows or prohibits certain conduct on the part of the insurance companies.

[52] 509 U.S. 764 (1993).

[53] Prior to 1980 or so the ISO had an "occurrence form" for certain liability policies. This meant that an insurer was liable for coverage if a loss occurred. The industry expected that this term would mean that that the loss occurred during the time when the insured was covered by the contract. However, in a set of court cases the courts interpreted the coverage more broadly holding insurers who provided coverage in say 1980

did not reach the issue of whether a boycott occurred in this case it provided guidance of such a determination. In fact, a boycott must be more than a refusal to deal. This would preclude a company from taking high-risk customers, for example. A boycott must include a refusal to deal based on other unrelated transactions. For example, if insurers also refused to sell insurance for other forms of coverage, a boycott might exist.

In sum, the antitrust exemption has been interpreted narrowly. One of the main arguments regarding the MFA was to allow smaller companies to share data because they would not have the actuarial staff or sufficient numbers of customers to set accurate prices using internal data. In fact, in most proposals involving repeal of the MFA this is the exemption that still remains.

B. Arguments for Repeal of the MFA

One of the basic arguments mentioned in *Southeastern Underwriters* was the fact that the insurance industry would be destroyed by competition and thus the state regulation of the business was needed to supplant the antitrust laws. Competition allegedly causes price decreases and insurers would have an incentive to lower prices so much that their solvency would be endangered. The whole rationale for rating bureaus like Southeastern Underwriters was to prevent this type of destructive price competition. This argument, which may have been valid in the past, is no longer viable today. Our understanding of competition and insurance pricing is much different than it was in the

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(and not previously) with covering a loss which occurred in say 1970. ISO changed the standard form to a "claims-made form". Under this form, an insurer was only liable for claims that were filed during the contract period, no matter when the loss giving rise to the claim occurred. Insurers would then underwrite based on expected claims that might occur to present conditions as well as past conditions. Allegedly, the ISO did not develop forms acceptable to the industry and the industry was able to recruit reinsurers who would agree to not accept reinsurance unless the form was changed to provide more protections for the insurers.

beginning of the twentieth century.[54] Actuaries can now price insurance products more accurately and the states have strengthened their financial standards and monitoring tools, which while imperfect, are better than the systems available to earlier insurance regulators.

While it is true that one of the major reasons insurers fail has to do with improper pricing and inadequate reserves (AM Best, 2002), there does not seem to be an apparent link between the competitive market environment and failure. If anything, competition puts poor managers to pasture, but it does not cause an insurance crisis.[55] It is true that some commercial lines markets are subject to cycles in the supply and price of insurance which can result in prices falling below insurers' costs. However, this is not the kind of phenomenon that warrants a return to uniform pricing subject to regulatory oversight. Most insurers survive "soft markets" with low or negative profits but their adverse performance does not threaten their solvency. A better regulatory approach for the small number of insurers that engage in excessively hazardous practices would be regulatory interventions against these insurers to correct this behavior. This approach, of course, would be most effective if US regulators improved their financial regulatory philosophy and methods as we discussed in Section V.

Further, we have seen numerous examples of how competition has worked well to serve the interests of consumers and insurers. Illinois, for example, does not require auto insurers to submit rates for regulatory approval. The Illinois market has thrived under

[54] A cursory reading of law review commentary of the time suggests that legal researchers never questioned the need for regulation as the market was not competent to provide the proper outcome. See, for example, Note, (1951), Kimball and Boyce (1952) and for a more recent example, see Zagalis (1994).

[55] Some may claim this as an overstatement as there is an allegation that medical malpractice insurers mis-priced medical malpractice liability risk which caused the most recent market disruptions in this market. See, Thorpe (2004). However, it could be that losses were higher than expected due to increases in medical malpractice liability judgments rather than under pricing or poor underwriting. See also Harrington and Litan (1988) for a discussion of the insurance crises of the 1980s in similar terms.

competition over a significant period of time (D'Arcy, 2002). Firms competed and yet there was no extraordinary level of insurer failures in Illinois. In contrast, Massachusetts imposed severe constraints on auto insurance rates which significantly reduced the number of auto insurers within the state (Tennyson, Weiss, and Regan, 2002).

One of the rationales consumer advocates employ when they argue for repeal is that all the industry's collusive behavior will vanish. However, since concentration measures and entry barriers in most markets are relatively low, it is difficult to see how the industry will be affected by repealing a rule which prevents collusion when the structure of insurance markets precludes collusion. During the last twenty years there have been numerous academic studies that demonstrate and conclude that insurance markets are highly competitive.[56]

In addition, while there is a general antitrust exemption of the insurance industry, it is narrow and many states have antitrust laws or consumer protection laws which apply to the insurance industry.[57] It is important to know that major states such as California, New York, and Florida have consumer protection or antitrust laws which apply to insurer behavior within the state. Even if these were the only states with such laws, repealing the antitrust law exemption would likely have little or no effect on major portions of the industry as they are participating in these three states.

The MFA is often employed as a cudgel by consumer advocates who insist that many problems in the insurance industry would be resolved if there was no antitrust exemption (see, for example, Angoff, 1986 and 1988 and Doroshow and Gottleib,

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[56] See, for example, Cummins and Weiss (1991), Klein (1995), and Grace and Klein (2007)

[57] Hawk and Laudati (1996) claim that all 50 states have either a statute or a state constitutional provision regarding antitrust.

2002).[58] The consumer advocates list of remedies is longer than merely the repeal of the MFA. However, the position is generally that any repeal would be part of a systematic and significant increase in state regulation. However, as we discussed earlier, empirical studies of insurance rate regulation have concluded that it provides negligible if any benefits but sometimes can cause significant problems if regulators attempt to suppress prices substantially below costs.

Other consumer advocates have a different list. For example, J. Robert Hunter, a well known advocate of repealing the MFA exemption, lists a number of reasons why the exemption should be repealed:

- Anticompetitive behavior by the insurance industry has been a prime cause of the homeowners insurance crisis along America's coastlines.

- State attorneys general have had to intercede to stop anticompetitive acts in the industry, including bid-rigging, market allocation arrangements and hidden kickbacks to brokers. This development has also demonstrated that state insurance regulation again has failed to police collusive behavior and that even the most sophisticated buyers are not able to protect themselves from such acts.

- Under threat of federal intervention, the insurance industry has been pushing states to deregulate insurance. This is an approach that makes no sense when collusion and cartel behavior is allowed.[59]

The three points are often used as condemnations of the industry. However, the presence of the antitrust laws may have no influence on these concerns.

The allegation that insurers are using an antitrust preemption to refuse to sell to customers is an old critique. It was used in the 1980s to suggest that the industry was

[58] Other items on the list of reforms include requiring more disclosure, allowing more competition with banks, allow joint underwriting arrangements, establish more state reinsurers and state run insurance companies, toughen enforcement, prohibit the revolving door between regulators and insurers, and establish independent consumer advocates. See Angoff (1986).

[59] U.S. Senate, Committee on the Judiciary, The McCarran-Ferguson Act: Implications of Repealing The Insurers' Antitrust Exemption, Testimony of J. Robert Hunter, Director of Insurance, Consumer Federation of America.

raising prices or causing shortages in order to extract collusive profits (Angoff, 1986). However, Harrington and Litan (1988) provide evidence that the liability crisis was due to the growth in losses. Current problems in homeowners insurance markets in coastal states subject to high hurricane risk have a similar explanation. Loss shocks and higher risk estimates have caused the supply of insurance to tighten but these markets will tend to move to new sustainable equilibriums if regulators allow them to do so.

Insurers' adjustment of their prices and exposures in these markets are actions consistent with the prudent management. Firms which separately decide to follow a certain strategy by merely refusing to write high-risk exposures is not, by itself, engaging in collusion. It is not even a boycott. Under the antitrust laws as applied to the MFA there must be some concerted behavior where coordinated action occurs.[60] The evidence indicates that insurers are behaving independently and following different strategies in adjusting their prices and exposures according to their specific circumstances (Grace, Klein and Liu, 2006).

For example, gasoline retailers are always raising and lowering prices based upon the market price of oil. This is in reaction to market changes and not collusion. Insurers raise and lower prices base on the market cost of risk capital. This price of capital has a great deal of influence on pricing and decisions to accept or keep business. Further, if there was concerted action to refuse to write policies in high risk areas, this action could violate the MFA's boycott provision thus bringing this same lawsuit into federal courts. Rather, what we see in states like Florida is a significant restructuring of the homeowners

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[60] St. Paul Fire and Marine v. Barry, 438 U.S. 531 (1978) where St. Paul asked its competitors to refuse to sell medical malpractice insurance to its customers in order to get its customers to take a new contract form. This was found to be a concerted action outside of the normal scope of the business of insurance to affect a boycott.

insurance market. The largest insurers have lost market share, some mid-tier writers have essentially maintained their portions of the market, and other insurers have increased their market shares. This picture is antithetical to what we would expect to see in a market where firms were orchestrating their actions to inflate profits.

State attorneys general have successfully sued various segments of the insurance industry even with an antitrust exemption.[61] At the federal level, lawsuits were entertained regarding the alleged boycott among various insurers, the ISO, and reinsurance regarding the change in the ISO standard liability contract. This is in part due to the boycott exemption in the MFA as well as plethora of state antitrust laws and consumer protection laws.

The final issue raised by Hunter is the "threat" of federal intervention such as that envisioned in the OFC and SMART Act proposals. However, the location, or level of, regulation has little to do with the presence or absence of antitrust exemptions.[62] Further, the elimination of unnecessary state regulatory constraints and barriers will likely increase the efficiency and competitiveness of insurers. Given that the presence or absence of a federal antitrust law has no real effect on the current insurance industry, one might argue that the repeal should be supported to remove a specious issue that is used to raise unsupported allegations of anticompetitive practices by insurers.

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[61] *Hartford Fire Insurance Company v. California,* 509 U.S. 764 (1993).

[62] In fact, the threat of regulation often has to do with the perceived failures of state regulation by either the industry or the federal government. As mentioned above early efforts for federal regulation were to avoid state regulation (as in *Paul v. Virginia*) and to avoid the increased regulatory scrutiny after the Armstrong commission in New York. Similarly, modern attempts to invoke federal regulation were due to the perceived failures of states to deal with insurance insolvencies in the 1970s-1990s. This later push for federal regulation was instituted, not by the industry, as much as by Congress. See U.S. House of Representatives "Dingle Report" (1990). The most recent proposals to have federal regulation are ostensibly related to reducing compliance costs, as we discuss.

C. Arguments for the Status Quo

One of the arguments for the status quo is the ability of companies to share data. The concern is that eliminating the pooling and analysis of loss data would undermine accurate pricing by insurers, particularly smaller companies that are more reliant on industry data. However, if there is a repeal of the MFA, one could readily argue for an exemption for this particular activity. The Sherman Act prohibits contracts, combinations, and conspiracies in restraint of trade. Price fixing has been held to be a *per se* offence, under the Sherman Act § 1's *Rule of Reason* test. However, one can potentially make the case that data sharing is not price fixing and is pro- competitive in effect, and thus would be permissible under the law even without the MFA. In fact, in 1977 the Department of Justice undertook a study of insurance regulation (DOJ (1977). The Department of Justice concluded that certain joint activities including data sharing, product standardization, assessment of community fire standards and the like would be permissible under the Sherman Act as they have a pro-competitive rational as they are used to reduce the cost of insurance.

Data sharing also has a pro-competitive rationale as it increases the number of firms willing to write business since it reduces the cost of pricing insurance. Because data sharing and other cost-reducing actives are arguably the only kinds of cooperative behavior that might be allowed under the narrow antitrust exemption provided by the MFA, why repeal the exemption? Replacing the law, even with a well-crafted safe harbor provision, will likely lead to uncertainty and raise costs to the firms who would use this data sharing arrangement.

The MFA gives each state the right to choose the style of regulation consistent with the preferences of its voters. Some states might permit more joint behavior than others. Repeal would provide a federal standard for how insurers should behave in every state. However, as mentioned above many, if not all, states have antitrust laws which would prohibit the same type of behavior under state law that the Sherman Act proscribes.[63] Presumably, this enforcement is the state's prerogative. Further, we do not see many antitrust cases brought at the state level based on state law.[64] This could be for two reasons; either the industry has not engaged in any anti-competitive behavior under state law or there are no willing plaintiffs. Presumably, the state antitrust or consumer protection law provides a right of a private cause of action so that any aggrieved party with an antitrust injury could present a case to a state court. In addition, most state consumer protection laws provide the state with the right to enforce the law.

D. Winners and Losers If MFA Is Repealed

A repeal of the antirust exemption of the MFA would yield winners as well as losers. If there is no safe harbor provision, then the winners will likely to be those large companies with sufficient actuarial resources and databases that they do not need to rely upon data and analysis from statistical or advisory organizations. As mentioned above, most of the premiums are written by organizations large enough to obtain credible loss estimates using their own data. Losers will be those relatively small companies with

[63] New York's antitrust law for example, dates from 1893, and follows in many respects the Sherman Act. Section 340-347 New York General Business Laws. In particular, Section 340(2) applies specifically to "licensed insurers, licensed insurance agents, licensed insurance brokers, licensed independent adjusters and other persons and organizations subject to the provisions of the insurance law,…"

[64] New York's action against the brokerage industry is an important exception. However, the rarity of these types of cases proves the point.

single state operations or niche companies without the ability to produce credible loss estimates on their own.

If an explicit data sharing exemption is not permitted, then many of these companies will need to sell and be absorbed by larger competitors. Repeal of the MFA could thus lead to industry consolidation. This would likely be an unintended consequence of MFA repeal, but maybe a good consequence as many of the small single state firms are inefficient compared to their competitors in the same lines of business (Cummins and Weiss, 2000). However, it is possible that insurers operating in certain lines of business that are not able to obtain large economies of scale due to the niche of risks which they cover would likely experience cost increases if data sharing is no longer permitted. These insurers are likely to be commercial specialists that cover only certain types of risk. Without data sharing they will have to price more conservatively since they can not estimate the underlying loss distribution.

Consumers would also win (or at least they will not lose). If there was collusive behavior arrested by the repeal of the MFA, this bad behavior could be deterred or enjoined through operation of the law. The potential for enforcement would keep the industry competitive. If there is, in fact, no existing collusive behavior, then consumers can be assured that there is an antitrust law that could be employed in the event of future collusion. To the extent that the repeal causes consolidation, then overall insurer efficiency will rise and society will benefit in the sense that more insurers are producing efficiently.

Finally, states may lose if the MFA is repealed. Under traditional antitrust laws, a well designed and supervised regulatory plan directed by the state may survive an antirust

challenge due to the so-called antitrust state action doctrine. Essentially, this doctrine requires active state supervision of a plan that may restrain competition. A joint underwriting association (JUA) where the state did not actively supervise the rates and conduct of the JUA would fail to meet this test under current interpretations of the state action doctrine.[65] Thus, if the state desires to intervene in the insurance market it must do so wholeheartedly and can not delegate unsupervised authority to private parties. At first blush, most states would not likely undertake this kind of delegation because it seems to be anticompetitive in nature. However, what about organizations whose purpose is to design common insurance contracts? What about self-regulating organizations which promote ethics in marketing? What about rating agencies? Each of these activities undertakes actions which are akin to regulation, but are outside the direct preview of the state under current law and regulation. The state may approve of these activities, but it unlikely that mere state approval will protect the activities under the state action doctrine.

All changes to law create uncertainty and repeal of the MFA will create uncertainty. Even with safe harbor provisions, there will be still questions about what types of joint activity are permissible. This uncertainty will impose costs on the states as well as the industry.

F. Concluding Thoughts

[65] See *California Retail Liquor Dealers Association v. Midcal Aluminum, Inc.* 445 U.S. 97 (1980) where the Court held that the state must (1) actively supervise (2) a clearly articulated an affirmatively expressed state policy that has the effect of retraining competition. If both conditions are met, then the state action doctrine immunizes the activities of private actors under direction from state. We should note that JUA's are one of several forms of residual market mechanisms that states establish to provide insurance coverage to consumers who are unable to obtain it from a private insurer in the "voluntary market." This is one of several examples of state-created associations or organizations of insurers to serve certain consumer and market needs.

The antitrust exemption under the MFA is quite narrow. Permitted activities are those that have a potential beneficial effect on competition. These include data sharing, joint development of products and policy forms, and other joint ventures which expand the insurance market, lower costs and increase competition. These same activities are likely to be viewed as legal without the MFA antitrust exemption. Because the interpretation is narrow and seems to match the types of behavior subject to the *Rule of Reason* test, it is almost immaterial whether the exemption is repealed. At the margin, however, the repeal of the MFA antitrust exemption would create uncertainty surrounding these arrangements which can only be resolved though litigation. This litigation could be costly and also could have a chilling effect on activities that enhance the efficiency of insurance markets.

VI. Summary and Conclusions

In sum, the economic and political context surrounding proposals for insurance regulatory reforms is complex. The proponents of federal regulation believe they have a strong case and there are a number of arguments that can be made in support of a federal framework. However, the real world is messy and advocates of federal regulation face formidable political opposition that has so far stymied OFC legislation. Further, even academic experts are not uniformly in favor of the kind of federal system that the largest insurers advocate, although most support significant reforms. Fortunately, from our point of view, the changes contemplated for the industry's antitrust exemption should not be problematic and may prove to be the least controversial.

Unfortunately, the same cannot be said for other institutional and policy reforms. Both practical considerations and politics will encumber efforts to rationalize insurance regulation. Hence, a major revamping of the current system is unlikely to occur in the near future. What we are likely to see are "smaller" incremental changes at both the state and federal level which have been the industry's historical legacy. These changes will not achieve the objectives of reformists, but they may help set the stage for more substantive reforms under more favorable political conditions. The topic of insurance regulation and its transformation will continue to provide rich ground for research and discussion by scholars and practitioners.

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Table III.1

Property-Liability Insurance Trends: 1996-2002

	1960	1970	1980	1990	1995	2000	2002
No. of Companies	NA	2,800	2,953	3,899	3,358	3,215	3,330
Assets ($M)	30,132	55,315	197,678	556,314	765,230	1,034,090	1,152,237
Revenues ($M)	15,741	36,524	108,745	252,991	296,637	341,590	411,396
Net Premiums Written (%)	95.1	94.3	89.6	86.9	87.6	87.7	90.3
Investment Income (%)	4.9	5.7	10.4	13.1	12.4	12.3	9.7
Market Share of 10 Largest Insurer Groups (%)	34.4	36.8	38.2	40.3	40.0	43.7	43.8*
Premiums/Surplus (%)	125.5	210.2	183.4	157.6	113.0	75.6	99.8
Return on Net Worth (%)	NA	11.6	13.1	8.5	9.0	6.5	-2.3*

* Figures for 2001

Source: NAIC, A.M.Best, and Insurance Information Institute

Table III.2

Life-Health Insurance Market Trends: 1950-2002

	1950	1960	1970	1980	1990	1995	2000	2002
No. of Companies	649	1,441	1,780	1,958	2,195	1,715	1,268	1,076
Assets ($M)	64,020	119,576	207,254	479,210	1,408,208	2,143,500	3,185,945	3,380,000
% 10 Largest Insurer Groups	na	62.4	57.7	52.5	36.7	36.1	41.7	45.9
Income ($M)	11,337	23,007	49,054	130,888	402,200	512,198	826,660	734,013
% Life Insurance Premiums	55.1	52.1	44.2	31.2	19.1	19.3	15.8%	18.3%
% Annuity Considerations	8.3	5.8	7.6	17.1	32.1	31.2	36.7%	36.7%
% Health Insurance Premiums	8.8	17.5	23.2	22.4	14.5	15.7	12.8%	14.8%
% Investment Income	18.3	18.7	20.7	25.9	27.8	27.4	25.2%	24.6%
% Other	9.5	5.8	4.4	3.3	6.5	6.4	9.5%	5.5%
Policy Reserves ($M)	54,946	98,473	167,779	390,339	1,196,967	1,812,325	2,711,420	2,507,314
% Life	na	71.9	68.8	50.7	29.1	28.2	27.4%	33.2%
% Annuities	na	27.2	29.1	46.5	68.1	68.3	69.1%	62.4%
% Health	na	0.9	2.1	2.8	2.8	3.5	3.5%	4.4%
Net Rate of Investment Income (%)[1]	3.1	4.1	5.3	8.1	9.3	7.9	7.1	5.4
Capital Ratio (%)[2]	na	na	9.7	9.2	8.5	10.7	11.2	9.3
Return on Equity (%)	na	na	na	13.9	10.7	11.0	10.0	7.0[3]

[1]Net investment income divided by mean invested assets (including cash) less half of net investment income.

[2]Capital plus surplus plus Asset Valuation Reserve divided by general account assets.

[3]Figure for 2001

Source: American Council of Life Insurance, A.M. Best, Fortune Magazine, and Forbes Magazine.

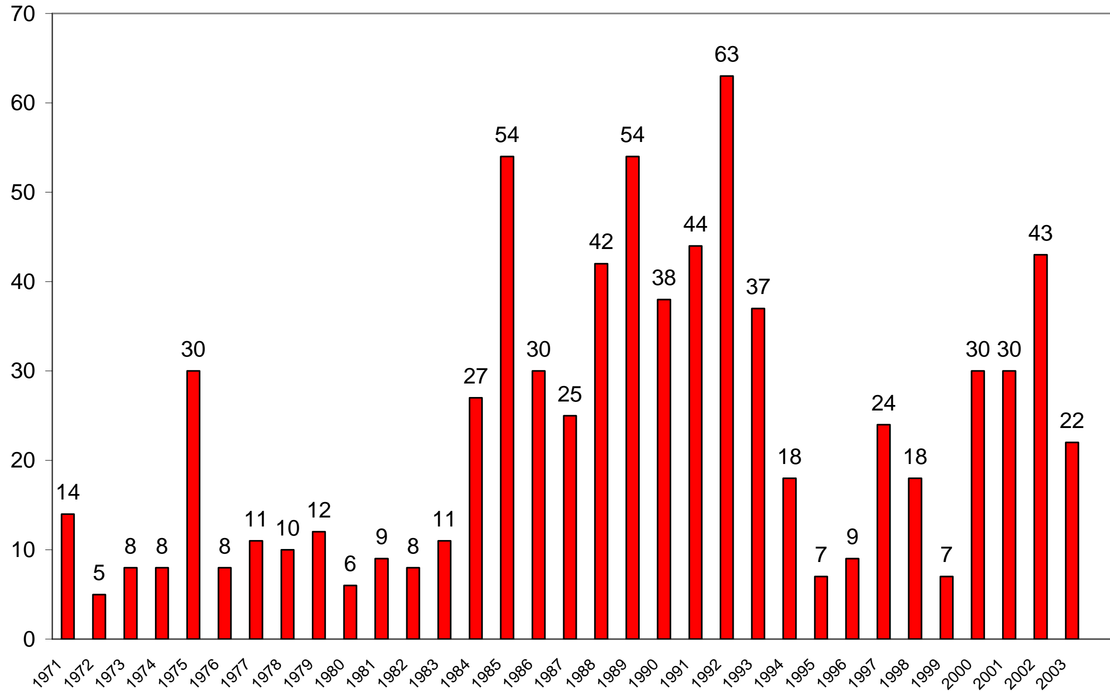
Figure III.1
Property-Casualty Insurer Failures: 1971-2003
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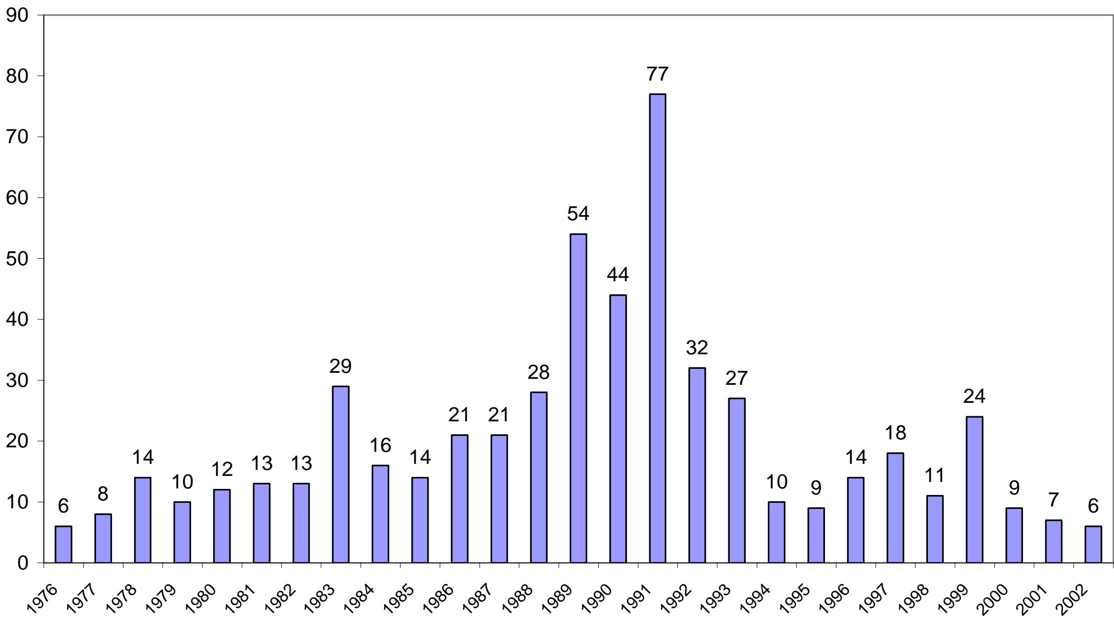
Figure III.2
Life-Health Insurer Failures: 1976-2002



Source: A.M. Best (2004)

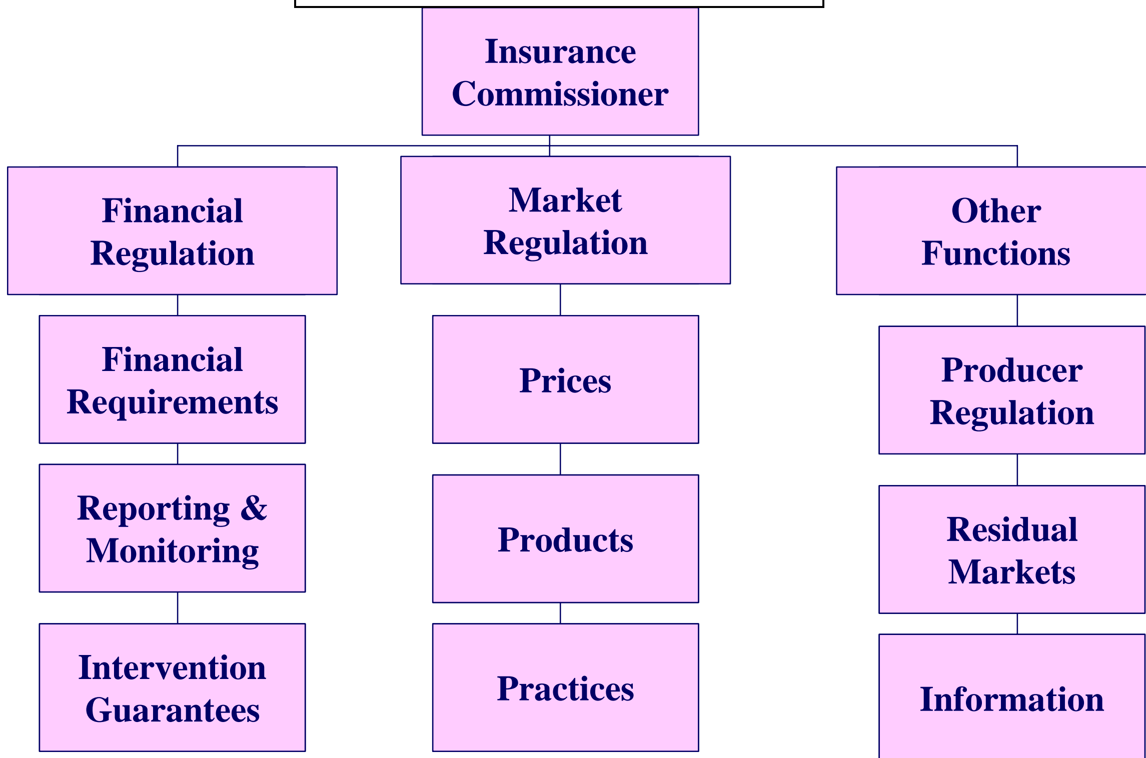


Figure IV.1
Insurance Regulatory Functions
Insurance Commissioner
Financial Regulation
Market Regulation
Other Functions
Financial Requirements
Prices
Producer Regulation
Reporting & Monitoring
Products
Residual Markets
Intervention Guarantees
Practices
Information

Table V1.1 Simple Comparison of U.S Insurance Industries, 1945 and 2006

	Premium Volume			Continetal US		
	Property-Liability	Life	Population	POP per Sq Mile	Autos*	Autos Per Capita
1945	17,426,483,200	$ 58,788,800,000	141,183,318	44.2	25,691,494	0.182
2006	$ 443,800,000,000	$ 591,903,000,000	298,754,819	84.6	134,012,369	0.449

	Number of Companies		Assets		
	Property-Liability	Life	Life	Property-Liability	Ratio of PC Assets to Life Assets
1945	588	348	$ 501,726,400,000	$ 10,740,520,000	2.14%
2006	2648	1257	$ 4,836,215,000,000	$ 1,483,013,000,000	30.66%

Sources: Automobiles (incld'g Taxis), 1945, Public Roads Administration, Highway Statistics, 1945. Does not include AK and HI.
Automobiles, 2006, US Dept of Transportation, Fed. Highway Admin, Highway Statistics 2005,
http://www.fhwa.dot.gov/policy/ohim/hs06/motor_vehicles.htm.
Population (average of 1040 and 1950) annual Census Statistics. http://www.census.gov/population/censusdata/table-2.pdf.
Population 2006, US Census Bureau, national and State Population Estimates, http://www.census.gov/popest/states/NST-ann-est.html.
Housing units 2006 from US Census Bureau, Housing Estimates, 2006.
Remaining data from the Statistical Abstract of the United States various years.
All dollars in 2006 dollars using U.S. Bureau of Labor Statistics historical series.

Table VI.2

Property-Casualty Insurers Grouped by the Number of States in Which They Operate

	N	Mean	Sum	% of Total Premiums
Groups and Companies with 17 or More States of Operation	242	$ 1,771,492,890	$ 428,701,279,380	81.65%
Groups and companies with less than 17 States of Operation	979	$ 98,437,211	$ 96,370,029,481	18.35%

Total Premiums for all groups and unaffiliated singles with total nationwide premiums greater than $100,000.

Source NAIC Annual Statement files, 2006.