STATE REGULATION OF INSURANCE: ITS OWN WORST ENEMY – REVISITED (SEMINAR ON PROFITABILITY, 4/91)

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The purpose of the seminar that you have been attending is essential: to provide an overview of total rate of return methodologies so that actuaries will be better able to understand how those methodologies relate to pricing.

It is not my intent today to engage in an analysis of the methodology, other than to observe that the implications of its application to a free market system are overwhelming.

It is my intent to discuss the politics of state insurance regulation that created and drive that methodology.

The use of rate of return by state regulators is an example of why efforts are underway in Washington that involve exploration of a greater federal role in insurance regulation, and preemption of certain aspects of state regulation.

In preparing my talk, I looked back at some of what I previously said about state regulation and federal alternatives. Comments and observations that I made as far back as 15 years ago seem worth repeating.

In 1979, right here in South Carolina, in a talk entitled "State Regulation of Insurance: Its Own Worst Enemy", I expressed my concern that:

> "Too frequently, state regulators, rather than responding to the substance of a federal contention that greater control over insurance is needed, try to prove that they can be tougher on the industry than the federal government.

"As a result, the merits of certain issues -- whether prior approval or competitive rating is a more efficient and equitable approach to insurance pricing, or whether cost-based pricing or rate equalization is more appropriate to private insurance system -- are not addressed, but rather the states seek to preempt federal attention by doing whatever the federal government is considering, and more so, before the 'feds' do it, regardless of whether that something is right or wrong."

I concluded that:

"Artificial rate ceilings, compulsion, uniformity and subsidy belie the 'claimed advantages' of state regulation. Firm regulation to assure fairness and protection is necessary and desirable. Defensive overregulation is neither in the interest of the industry nor of insurance consumers generally. If state regulators fail to distinguish between essential insurance principles and intuitive theories of cost equalization and do not begin to educate the public they represent on the implications of the difference, a profit motivated, private insurance system will not survive.

"We may not yet have reached the stage where insurers and others have nothing to lose by a change in regulatory forum, but it is not too soon to consider the alternatives."

Earlier, in an article in the April 1976 Best's Review, I went into some detail as to factors that might impel endorsement of a federal alternative to state regulation of insurance.

"The current quality of regulation in many states is so uncertain at best that without a basic change by the states in their regulatory direction, the future of the industry is in peril.

"The concern I express goes far deeper than to the lack of regulatory leadership that is necessary to produce stability in a regulated industry. It transcends the unhappy myopia through which states divert all but a small fraction of premium tax receipts to general revenue purposes, leaving insurance departments underfunded, understaffed and overdependent for technical expertise on the industry they are supposed to regulate. Perhaps this dependence is partially responsible for the defensiveness of many insurance departments in their unwillingness to take action, however proper and necessary, if insurers would appear to be the primary beneficiaries. Certainly, the short tenure of commissioners -- said to average less than two years -- accounts in some measure for the less than professional performance of some insurance departments.

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"[I]n conjunction with social developments of recent years, these regulatory shortcomings have produced an operating climate under which no industry can prosper and continue to perform those services which brought it into being."

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"It is, apparently, far easier for legislatures to require insurers to make their product available than to address the underlying cancers which produced the price or availability problem."

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"Nevertheless, it is the insurance industry that receives the public blame for the resultant increases in insurance premiums, and which is increasingly called upon to make its product available without regard to the risk assumed. It would not seem likely that this trend will be reversed, and like it or not, the industry will continue to be called upon, by statute, to sell insurance it does not wish to market, to risks that may not be insurable."

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"What is occurring, however, in too many states and in too many lines of insurance, is political rather than regulatory reaction to applications for rate relief. Judging by results, the first question asked by too many insurance departments is not 'is the filing accurate?' but 'how will the legislature and the public react to an increase in premiums?' Public hearings are held, speeches are made, postures are taken, and the ultimate standard of performance is who denounced the insurance industry most vigorously."

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"I recall that when we urged an end to prior approval in New York State, in 1969, we cited the unworkability of a ratemaking mechanism which by its very nature dictated that by the time rates were finally approved, they would be outmoded and probably inadequate. We cited the waste of regulatory time and manpower, which could better be put to other uses. We delicately alluded to the existence of political pressures on the regulator, being careful not to overemphasize this potentially embarrassing aspect of the issue. Certainly in the National Association of Insurance Commissioners and in various state legislative debates, the issue of political ratemaking inherent in prior approval was always carefully skirted.

"The movement toward open competition at the state level has, unfortunately, come to a standstill."

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"[I]t should, therefore, be no surprise that coming off a year which produced more than a $4 billion property/liability underwriting loss, many carriers that previously would have rejected any talk of even the most minute intrusion by the federal government are at least listening with interest to the proposals now being discussed in Washington. Faced with an increasing number of insurer insolvencies in the last few years, unable to obtain timely rate relief in prior approval states, and pessimistic about the likelihood of those states changing to an open competition mode, it is not surprising that insurers are questioning many basic tenets of regulation -- many for the first time.

"Adding fuel to the debate is the irony that what emerged in the last decade as an acclaimed solution to the incidence of insurer default -- insolvency funds -- have, in fact, insulated, at least temporarily, many regulators and legislators from the ultimate realities of rate inadequacy. Some insurance departments act as though the existence of insolvency funds permits depression of rates below adequate levels, because in the event of default, the policyholder will be protected. This dangerous game requires acceptance of the delusion that the whole is not equal to the sum of its parts. It overlooks the fact that someone has to pay for insolvencies, and where such funds are available, the cost is merely shifted to still solvent carriers. Theoretically, the cost is then passed on to policyholders of the solvent insurers, but in practice this does not occur to the extent that rates are artifically held down in prior approval states. Where the cost of the carrier's share of the insolvency is not recouped through rate increases, a drain on the surplus and capital of the carrier must occur.

"However elementary this logic, it does not seem to be sufficiently appreciated by the public, its legislators or even by regulators. Insolvency funds, even if they are not depleted by legislatures for general revenue purposes, are not cornucopias, and without adequate rates a cycle of insurer insolvencies is a certainty."

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"In 1962, the Assistant Attorney General in charge of the Antitrust Division, following the O'Mahoney Senate Antitrust and Monopoly Subcommittee hearings, endorsed the Kefauver bill which would have mandated an open competition rating law for property and liability insurance lines in the District of Columbia. Similarly, the Justice Department, in 1966, unsuccessfully intervened in a North Carolina lawsuit seeking to overturn that state's mandatory bureau rate system. Since that time, numerous Justice Department spokesmen have endorsed the principles of competitive rating laws as more compatible with antitrust principles than a regulated approach. Rate regulation may be appropriate in a public utility or monopolistic or oligopolistic context, but it has no merit when applied to a competitive industry like insurance with low concentration and relative ease of entry."

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"There are undoubtedly a few carriers which, if given the choice, would opt for an exclusive federal regulatory system. Regardless of the merits of such an approach, its chances of realization in the foreseeable future are minimal -- absent a total breakdown in state regulation for solvency and widespread financial disasters within the industry. But while it will probably take catastrophes of a monumental nature to shift the balance of political power so drastically from the extant state systems, the very shortsightedness that permits arbitrary rate suppression could actually produce the scale of insolvencies that could bring down state regulation."

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"[I]t is not likely that the commitment of insurers to state regulation is such that they can afford to ignore the interests of their policyholders and stockholders and fail to react to the treatment they are receiving in many states. Neither the principles of insurance regulation nor those of corporate responsibility contemplate economic suicide."

That was 15 years ago. It is hard to see what has changed for the better. The breakdown in state regulation that may be the precusor of federal regulation may be occurring.

Both the incidence and size of insolvencies has increased; markets, including commercial, have become less free; rates continue to be depressed based on political considerations; cross subsidization has increased; residual market shares have grown; the most competitive and one of the most attractive markets in the country -- California -- has been all but destroyed; and insurers are withdrawing from a growing number of states.

As increasing attention was given to public utility treatment of a competitive industry and "rate of return" supplanted cost based pricing, regulators lost sight of their <u>raison d'être</u> -- solvency regulation.

In any competitive market, players will fail, but when the insolvencies of just five insurers that became insolvent in the last few years account for a minimum of $4 billion, something is very wrong.

The overwhelming number of large recent insolvencies has not occurred in states with small insurance departments and inadequate resources, but in those with extensive expertise and reputations to match.

Some of these insolvencies can be attributed to the reckless competition of the late seventies and early eighties, some to unanticipated losses compounded by expanded legal theories of recovery, and some to negligent and even fraudulent management. But none occurred overnight, and the contributing factors are within the scope of what regulation is all about.

Each failure evolved under statutorily imposed regulatory regimes that were designed to prevent or promptly identify insolvencies and involved repeated review of annual statements and hands-on examinations by both domestic and foreign state regulators. Most of the significant insolvencies involved highly capitalized insurers who were licensed countrywide and who were covered by guaranty funds.

All insolvencies cannot be prevented. But those that occur must be responded to timely and losses must be contained.

The National Association of Insurance Commissioners has taken major strides in the last two years to improve the tools available to regulators. But lack of tools, financial resources and awareness of the troubled status of insurers has not been why state action on insolvencies has been too little, too late.

The major reason has been lack of regulatory will. Regulation is a very personal process. All the statutes, regulations and penalties are useless unless the regulator is willing to use them. The tendency of insurance commissioners to treat any insolvency as a personal failure and their willingness to indulge unrealistic hopes of recovery are exacerbated by the existence of guaranty funds. Because of these funds, which serve an important function for small policyholders, the regulator acts as if delay has no cost. The error of this belief is obscured by the time lag in receipt of the bill. Given the notoriously short terms of most commissioners, they will be long gone when payment comes due.

Any response to insolvencies that does not address the human nature of the regulatory dilemna will fail. Incentives must be created that put a greater penalty on delay than on prompt acknowledgement and action. One such incentive is to require domestic commissioners to annually rate insurers for relative solidity. If Best's can do it, so can the regulator charged by statute with solvency oversight. Unfortunately, reluctance to assume public responsibility for evaluating an insurer's solvency seems even greater than reluctance to act once the insolvency occurs.

The failure of state regulation to effectively manage its primary function -- solvency oversight -- may be the most significant factor that distinguishes current discontent with state regulation from that 15 years ago. Although the intensified politicalization of pricing and the presumptuousness of insurance departments in substituting their view of what coverage and terms they will permit to be negotiated between insurers and sophisticated business is fomenting increased disallegiance to state regulation, the interest in Washington in solvency may be what pushes some federal preemption over the top.

Several years of Congressional investigation of insurer insolvencies and the inadequacy of state response will, no doubt, result in legislative proposals to impose a federal role. Dual regulation being the *bête noire* of almost every insurer, the response may well be an endorsement of federal preemption, not just of solvency regulation but of all regulation of commercial insurers.

The extent of use of non-authorized offshore insurers, that fuels so much of Washington's concerns, is directly related to the interference by state insurance regulators with the commercial marketplace. The concern by U.S. insurers about their loss of business to offshore competition creates a natural fit with Congressional solvency concerns. Insurers who once were wedded to the sanctity of state regulation of insurance are finding economic concerns more compelling than ideology.

The most manifest demonstration of this fit is the growing effort to explore legislation that will establish effective federal solvency regulation and authorize federal chartering of commercial property/casualty insurers.

Under this approach, the regulatory focus of the federal regulatory entity will be on solvencv, without the distraction of price and form oversight and without the counterproductive presence of guaranty funds. The absence of guaranty funds will deprive the federal regulator of the luxury of someone else -- taxpayers or other insurers -- picking up the costs of its shortcomings. Unlike current state regulation with its guaranty funds and unlike federal banking regulation with its FDIC and FSLIC bailouts, the full burden and onus of solvency regulation will be on the regulator.

By their refusal to define and defend the free market necessary to a competitive insurance industry, the states may have succeeded in dissipating the once fervent support for state regulation of insurance. The opportunity for sound solvency regulation ~~of~~ at the federal level may finally provide the catalyst for industry support of a comprehensive program of federal solvency regulation, federal chartering of large commercial insurers and preemption for those insurers of all state regulation.