

Despite some setbacks, insurance markets have become more competitive.

Repairing Insurance Markets

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CONGRESS PASSED THE McCARRAN-Ferguson Act in 1945 in response to a U.S. Supreme Court decision that insurance transacted across state lines was interstate commerce and subject to federal antitrust law. The court decision challenged state insurance regulation and insurers' cooperative arrangements to fix prices through state ratings bureaus. The McCarran-Ferguson Act constrained the high court's decision by stipulating that state regulation is in the public interest, federal law does not apply to insurance unless specifically indicated, and federal antitrust law does not apply to insurance for activities that are regulated by the states and do not involve boycott, coercion, or intimidation. Despite periodic pressure and proposals for federal regulation, state insurance regulation has managed more or less to retain its exclusive franchise.

Most states enacted prior-approval regulation of property/casualty insurance rates immediately following passage of McCarran-Ferguson. The regulation required or strongly encouraged insurers to charge bureau rates, and the bureau rating system was gradually modified during the next two decades. Beginning in the late 1960s and early 1970s, a significant number of states adopted "competitive rating" for many types of property/casualty insurance. Rates generally had to be filed with regulators, but they did not need to be approved before use. Other states resisted the temptation to adopt competitive rating and, in some cases, have used regulation to constrain rate increases and restrict rate classification.

The last 25 years have witnessed a slow and non-monotonic expansion of competitive rating. That has included the sub-

stantial deregulation of property/casualty insurance rates and policy forms (i.e., contract terms and language) for "large" commercial buyers in approximately 20 states since 1998. However, rate regulation persists in many states, despite overwhelming evidence of abundant market competition and the counter-productive effects of rate regulation as practiced in some states. Representatives of certain segments of both the property/casualty and life/health/annuity sectors are now pressing for optional federal chartering and regulation that they hope will free their companies from the shackles of outmoded state regulation of rates and forms.

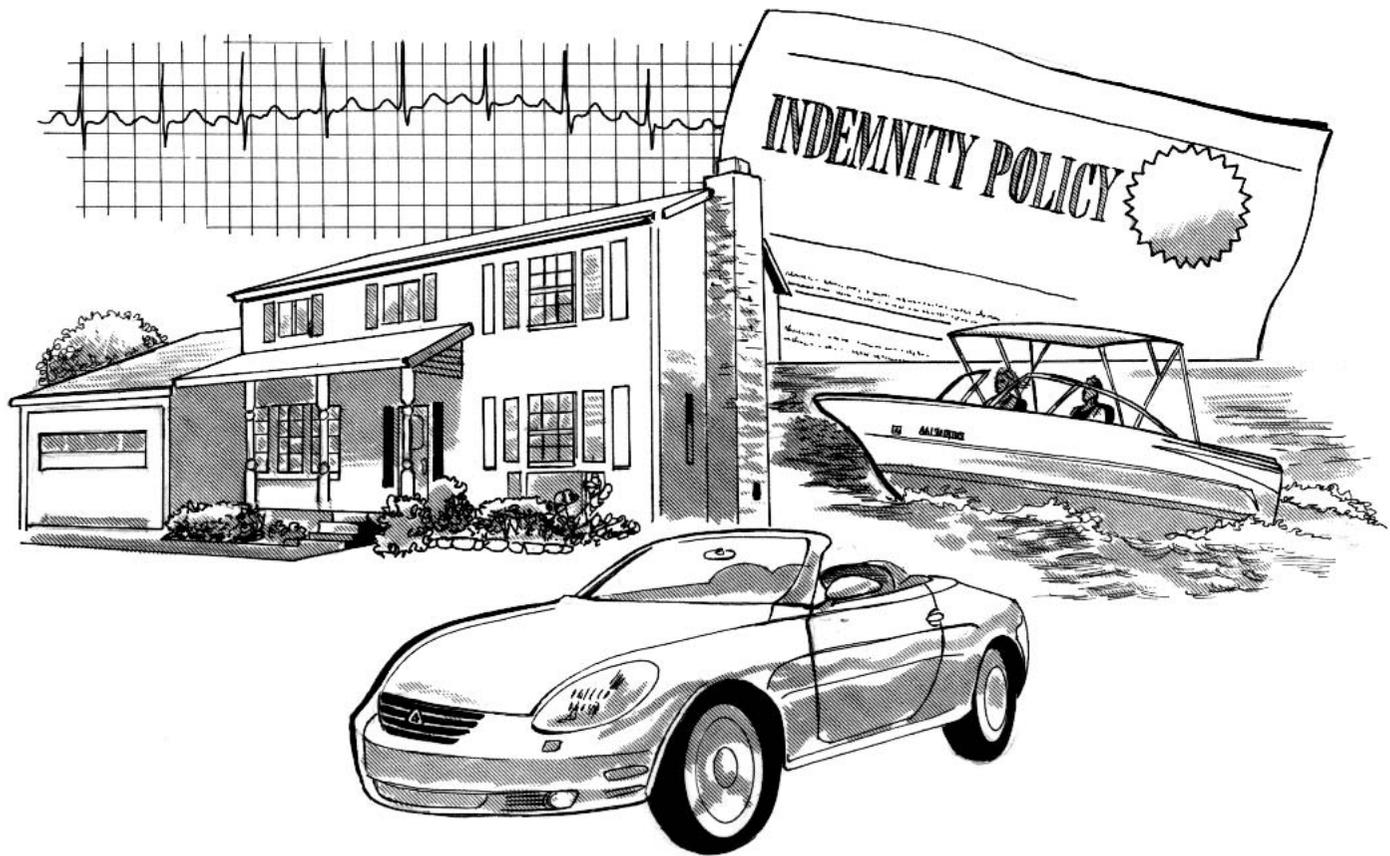
COMPETITIVE INSURANCE MARKETS

Market structure and ease of entry are highly conducive to vigorous competition in auto, home, and most other types of property/casualty insurance. Modern insurance markets that are relatively free from regulatory constraints on prices and risk classification exhibit pervasive evidence of competitive conduct and performance. Insurers vary substantially in terms of price, underwriting standards, and service. Property/casualty insurance profitability is modest compared to other sectors.

Competition creates strong incentives for insurers to forecast costs accurately and to price and underwrite each policyholder so as to avoid adverse selection. Thus, competition produces highly refined underwriting and classification systems. Prices vary across insurers in relation to the stringency of classification and underwriting standards. The pressure for increased accuracy is relentless. Insurers that predict claim costs better than their competitors prosper. Insurers that respond slowly end up insuring a disproportionate volume of business at inadequate rates; they lose money and either take corrective action or disappear.

Competitive insurance markets allow policyholders to spread the risk of unexpected loss. Insurance involves cross-sub-

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sidies ex post: Policyholders whose losses turn out higher than predicted are indemnified, de facto, by policyholders whose losses turn out lower than predicted, with insurer capital serving as a buffer when aggregate losses are unexpectedly large.

Competitive insurance markets minimize cross-subsidies ex ante: Prices vary in relation to buyers' expected claim costs (or, more formally, in relation to insurers' conditional expectations of buyers' claim costs), given available information to form expectations. Policyholders with relatively high (or low) predicted claim costs pay relatively high (or low) premiums. The resulting system of "cost-based" pricing motivates parties with relatively high risk to take precautions and alter their activities.

Absent long-term contracts that shift to insurers the risk of changes in expected losses over time, changes in competitive premium rates largely reflect changes in conditional expectations of claim costs. Intertemporal variation in competitive premium rates therefore provides information about variation in expected losses and again motivates desirable risk management.

To be sure, competitive insurance pricing is unavoidably imperfect because of inherent uncertainty about future behavior and events. Imperfect classification generates some degree of adverse selection (parties with higher but unobservable risk of loss tend to buy more coverage than parties with lower risk of loss). Lower-risk parties pay more for coverage (and often buy less coverage) than would be true with perfect (or symmetric) information. In addition, unexpectedly large claim costs (or reductions in asset values) and simultaneous reductions in capital for large numbers of insurers sometimes cause or contribute to "hard" insurance markets. Premium rates go up faster than contemporaneous expectations of claim costs,

making rate changes a less informative indicator of changes in expectations. That increases the volatility of premium rates over time, and reduces policyholders' ability to transfer risk.

INSURANCE REGULATION

Competitive insurance markets promote widespread availability of insurance. State residual markets (mechanisms that ensure the availability of coverage and force insurers to divvy up applicants for which prices are perceived as too low) usually are very small in states with little or no regulatory intervention in pricing. Some consumerists argue that small residual markets improperly measure availability, alleging that excessive insurer "selection competition" relegates many policyholders to non-standard markets (insurers that specialize in providing coverage to policyholders who do not meet the underwriting standards of lower-priced insurers) with higher prices and lower service. In reality, thriving non-standard markets are indicative of robust and beneficial competition. They reflect insurer specialization to achieve greater refinement in cost-based classification, which in turn helps promote efficient risk management.

Regulated markets High insurance rates for some cohorts within a market can create substantial political pressure for government intervention to suppress their rates. In the short run, regulatory suppression of rates for policyholders with relatively high predicted costs may expropriate wealth from insurance company owners, with government-mandated residual markets forcing all insurers to participate in the sale of underpriced coverage. In the longer run, rate suppression for high-risk buyers is economically unsustainable unless higher rates

are permitted for lower-risk buyers, so that insurers can achieve normal expected returns on capital.

The cross-subsidy of some high-risk customers by higher-than-necessary premiums for lower-risk customers distorts incentives to manage risk, increases the total cost of risk, and very likely increases total claim costs and premiums. Those who advocate rate regulation and cross-subsidies rather than competitively determined rates argue that policyholder behavior is largely or completely insensitive to prices. Although the relevant elasticities may sometimes be small, they seldom are zero and sometimes are quite large.

Under rate regulation, political pressure also causes regulators to deny or delay market-wide rate increases necessitated by rapid escalation in expected claim costs. When that occurs, insurance company owners suffer losses, residual markets grow, and insurers' incentives for providing high quality coverage diminish. By masking information that would otherwise be conveyed by higher premium rates, regulatory rate suppression reduces incentives for private risk management and public action (such as changes in traffic safety enforcement, crime prevention, and liability rules) that might efficiently reduce expected claim costs and premiums. Claim costs again tend to increase faster, which ultimately requires higher premiums than if rates had not been suppressed.

Rate competition Consumerists often allege that the antitrust exemption for insurance requires price regulation to prevent supra-competitive price fixing. However, with the exception of insurers in states with heavy rate regulation, modern property/casualty insurance markets are characterized by substantial variation in prices and underwriting standards among insurers. Rate regulation, rather than the limited antitrust exemption, limits competition and reduces price variation across insurers.

Rate advisory organizations, which succeeded ratings bureaus, promote competition by providing valuable low-cost information to insurers concerning projected loss costs. The insurers combine that information with their own data to improve forecasts. Greater forecast accuracy reduces insurer risk and the need for capital. The availability of loss projections based on market-wide data at relatively low cost reduces the cost of ratemaking, rate filing, and entry into new markets and lines of business.

Some career regulators view their mission as protecting consumers against inadvertently purchasing coverage from high-priced insurers. To be sure, some consumers may have difficulty comparing prices, thus allowing some high-priced, inefficient insurers to survive. But the better way to combat that problem is greater information disclosure, not rate regulation.

Fairness Some insurance regulatory efforts allegedly promote "fairness" through restrictions on certain types of risk classification. Examples include largely unsuccessful attacks in the 1970s on the use of gender in auto insurance rating, in the 1980s and 1990s on territorial rating in auto and homeowners insurance, and in recent years on the use of credit history as a rating or underwriting criterion in auto and homeowners insurance. Attempting to achieve greater fairness through rate regulation invariably requires some policyholders to pay higher rates if

insurers are to cover their average costs and expect a reasonable profit. Elaborate enforcement mechanisms are also required.

In addition to enforcement costs and the deadweight costs from distorting incentives for risk management, those rate increases create significant political discipline against regulation-induced cross-subsidies, provided that the regulatory process is sufficiently transparent to voters. That may help explain why arguments for classification restrictions usually are couched in terms of alleged "abuses" or "unfair practices" that benevolent regulation can remedy without requiring anyone to pay more.

THE TREND TOWARDS LESS REGULATION

Although the long-term trend in property/casualty insurance regulation has been towards greater reliance on market competition and less reliance on rate regulation, progress has been slow and not monotonic. Beginning in the late 1950s, most states began to make it easier for insurers to deviate from bureau rates. In particular, large direct writers of personal lines coverage (Allstate, Nationwide, and State Farm) generally obtained approval to charge lower rates and thereby grew rapidly, eventually eviscerating bureau dominance.

Beginning in the mid-1960s and continuing until the mid-1980s, a significant number of states adopted competitive rating laws (usually excepting workers' compensation insurance). That trend reflected several influences, including:

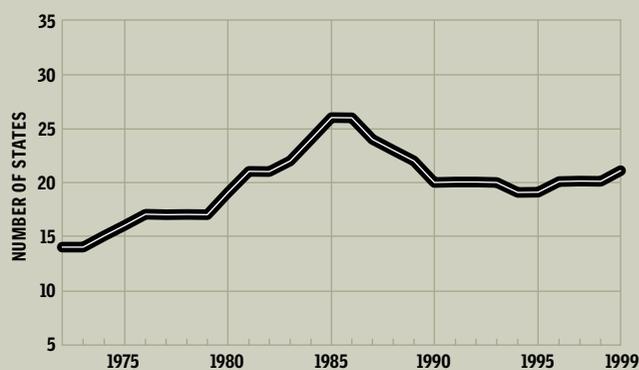
- The gradual erosion of bureau pricing and increased administrative costs associated with multiple rate filings by numerous insurers.
- Recognition that solvency regulation largely obviated rate regulation's possible role in preventing insolvencies.
- Evidence that competitive rating might lower rates and the hope in some states that price competition would ameliorate growing insurance affordability problems.

Return to regulation However, rapid claims cost growth in the 1970s influenced a number of states to eschew deregulation

FIGURE 1

Rise, Fall, and Return of Deregulation

Number of states with competitive rating laws for personal automobile insurance: 1972-1999



and instead increase the intensity and scope of rate regulation in an attempt to make coverage more affordable. The trend continued in conjunction with strong cost surges in the 1980s. The culmination came with the passage of Proposition 103 in California in 1988, which included a mandatory 20-percent rate rollback provision, requirement for an elected insurance commissioner, and ostensible restrictions on classification. A number of other states with competitive rating laws reenacted prior-approval laws in the late 1980s. Figure 1 shows the trend in automobile insurance competitive pricing laws over time.

The 1980s also saw widespread regulatory suppression of workers' compensation rates in the presence of rapidly rising loss costs. Residual markets mushroomed in size and often became a vehicle for rate suppression. Residual market deficits exploded, leading to increases in prices for employers insured in the voluntary market. Many employers were motivated to self-insure, which reduced the voluntary market assessment base for recovering residual market deficits. As I will discuss later, evidence suggests that regulation-induced subsidies to higher-risk employers aggravated claim cost growth.

The 1970s and 1980s thus reflected two divergent trends. Some states substantially eliminated prior-approval regulation. A number of others changed the emphasis of prior approval from rate adequacy to more restrictive and comprehensive controls on prices, with the goal of limiting rate increases and holding down premium rates. A few states adopted rate-of-return regulation patterned after procedures used for public utilities, producing lengthy debate over most facets of the ratemaking process. Some states adopted procedures to discourage insurer exit in response to regulatory rate suppression; those regulations included requiring an insurer to exit all lines in the state if it exits a given regulated line, permitting only gradual withdrawal, or levying exit fees to go towards future residual market deficits or guaranty fund assessments.

The 1990s The last decade has seen significant, albeit uneven, progress toward greater reliance on competitive pricing. (See Table 1.) Growth in claim costs slowed substantially in auto and workers' compensation insurance. Favorable cost trends in workers' compensation in part reflected state benefit reforms. During the early 1990s, many states also modified their systems of voluntary and residual-market rate regulation to permit higher rates and provide employers and insurers with greater incentives for loss control. Some states eliminated prior approval of workers' compensation insurance rates for the voluntary market. The changes were followed by substantial depopulation of workers' compensation insurance residual markets.

State experiences Several states with the largest residual markets for automobile insurance also adopted significant reforms. Notable success stories include

South Carolina's auto insurance market, in which the state dismantled its 25-year-old system of mandatory coverage offers by insurers ("take all comers"), a state-mandated class plan, prior-approval regulation of rate changes, and a large residual market with massive deficits financed by recoupment fees on all drivers. The results of permitting much greater freedom in pricing and underwriting included entry into the market by dozens of auto insurers and substantial depopulation of what had been the nation's largest residual market.

Substantial entry and residual market depopulation also accompanied pro-competitive, regulatory reforms in the District of Columbia. Perhaps most important, during 1998-2002 (mainly during 1998-1999) over one-third of the states deregulated rates and (in many cases) policy forms for "large" commercial insurance buyers, thus eliminating rate- and form-filing requirements. Although the effects of regulation may have been modest prior to those reforms in some states, that development is remarkable.

Antecedents The sporadic movement toward less regulation of rates reflects a variety of influences. The most important factors include:

- Expanded recognition of rate regulation's inability to make insurance more affordable and the significant adverse effects of attempting to do so.
- Increased awareness and concern with the direct and indirect costs of state regulation of prices, policy forms, and producer licensing.
- The accumulation of evidence that competitive rating was effective and beneficial.
- Broader support for competitive rating by insurance companies that had lost the benefits of price floors and had tasted regulatory rate suppression.
- Favorable trends in claim costs for auto and workers' compensation insurance in the 1990s, which allowed deregulation to be accompanied by rate reductions (or at least did not require large rate increases).

Analysis Empirical research has compared insurance loss ratios (ratios of losses to premiums) in prior-approval and competitive-rating states to provide evidence of whether prior approval affects average rate levels in relation to claim costs. Consistent with rate suppression in some states, some studies provide evidence of higher auto insurance loss ratios in states with prior-approval rate regulation during the 1970s and early 1980s, but there appears to be no consistent difference in loss ratios over longer horizons.

In a study published in the recent book *Deregulation of Property/Liability Insurance*, I

TABLE 1

Slow Return to Competition

Number of states with competitive-rating laws, 1992 and 1999*

Type of Coverage	1992	1999*
Personal auto	20	21
Homeowners	25	26
Workers' compensation	12	17
General property/casualty	22	31

*During 1999-2002, 19 states eliminated rate regulation and filing requirements (and in many cases form-filing requirements) for "large" commercial insureds.

examined automobile insurance loss ratios, residual market shares, and volatility of expenditure growth rates with cross-state data for the past 25 years. The estimated average effect of prior-approval regulation on loss ratios is positive, but it is negligible in magnitude (primarily attributable to the 1970s). At most, it is weakly significant in a statistical sense. Consistent with earlier work, I found that prior-approval regulation is persistently and reliably associated with larger residual market shares, even when states with the largest residual market shares are excluded from the comparison. Prior approval regulation also is reliably associated with greater volatility in loss ratios and expenditure growth rates. The overall findings suggest that, on average, prior-approval regulation had little or no effect on the relation between rates and claim costs over time, but it reduced coverage availability and increased volatility to insurers and consumers.

My earlier research with Patricia Danzon on workers' compensation insurance rate regulation explained how rate regulation that produces temporary suppression of rate changes or chronic cross-subsidies from low- to high-risk employers could produce higher claim costs by distorting incentives of employers and insurers. We tested those predictions using data during the 1980s' cost surge in workers' compensation. The results suggest that rate suppression in workers' compensation insurance in the 1980s and early 1990s was positively and significantly related to growth in claim costs.

Recalcitrant states Prior-approval regulation in some states is relatively benign; it does not substantially delay or interfere with market pricing. The main problem instead lies in states where regulation materially delays rate and form changes, chills competition and innovation, and produces chronic cross-subsidies. Why do those policies — discredited both intellectually and empirically — persist in some markets?

Auto, homeowners, and workers' compensation insurance remain highly politicized in some states, including California, Florida, Massachusetts, New Jersey, New York, and Texas. When it comes to insurance, many voters in those states are inclined to support command-and-control policies, even if they reject such policies generally. Sizable rate increases and "unaffordable" rates create large constituencies that favor rate suppression, especially when its adverse consequences may be difficult to discern, at least in the short run. Removal of chronic cross-subsidies in states like Massachusetts and New Jersey, which tend to be opaque to policyholders who bear the cost, would likely require rate increases for many buyers. As in other industries, deregulation of insurance prices is much more likely when it will reduce, or at least not increase, rates for a large majority of customers.

Entrenched regulatory bureaucracies form a second formidable obstacle to desirable reform. People who have self-selected into careers involving rate and form approvals are resistant to change, even apart from self-interest. They believe that regulatory micromanagement of business practices and insurer-policyholder relations serves the public interest. They let their desires for the perfect — or their perceptions of the perfect — get in the way of the good that can be achieved by regulatory systems that rely on and promote competition. Interest groups that benefit from high claim costs may oppose

regulatory reform in some states out of fear that it might increase pressure for public policies to control costs (such as tort or workers' compensation reform).

FEDERAL (DE)REGULATION?

The enactment of the Graham-Leach-Bliley Act in 1999 increased debate over the residual sins of state regulation, particularly the direct and indirect costs of state regulation of rates, forms, and producer licensing. Those debates come in an era of financial modernization, growing electronic commerce, and global competition. In a key development, representatives of many large property/casualty insurers specializing in business insurance, and their main trade association, now openly advocate optional federal chartering and regulation as a means of regulatory modernization (i.e., of escaping inefficient state regulation of rates and certain forms). Representatives of many life insurance and annuity companies also favor optional federal regulation as a means to escape inefficient form regulation and compete more effectively with banks.

State responses to demands for insurance market reform include the previously discussed elimination of prior-approval regulation of rates and policy forms for "large" commercial buyers. A large majority of states passed laws to meet Graham-Leach-Bliley provisions dealing with reciprocity for non-resident producer licensing. The states thus avoided federal licensing of producers, which the act mandated unless a specified number of states met its provisions within three years of enactment. What is more, various National Association of Insurance Commissioner (NAIC) working groups are attempting to develop uniform state standards and centralized approval for rate and form filings for "appropriate" products, further streamline and homogenize rate filing and review processes, and promote regulation that recognizes competition.

Dual chartering benefits? Those state actions have not prevented numerous proposals for dual chartering. The American Bankers Insurance Association has proposed a bill patterned largely after bank regulation. Rep. John LaFalce (D-N.Y.) and Sen. Charles Schumer (D-N.Y.) have introduced optional federal chartering bills with a number of similar features. The American Insurance Association, which primarily represents relatively large property/casualty insurers that specialize in commercial lines, has proposed dual chartering for property/casualty insurers. The American Council of Life Insurers has proposed dual chartering of life and annuity insurers.

Optional federal chartering for insurance companies might offer several efficiencies. According to proponents, it could:

- Enhance competition by streamlining, centralizing, or eliminating antiquated regulations of multi-state insurers and insurance producers.
- Provide federally chartered insurers with a broad exemption from state regulation of rates and contract forms.
- Promote beneficial regulatory competition between federal and state regulators.

- Avoid excessively burdensome consumer protections and eschew mandates that ultimately would require policyholders to subsidize particular sectors or groups.

Then again, optional federal chartering might achieve few or none of those results and might harm competition, safety, and soundness.

Centralization Because the need for coverage and terms of coverage are closely linked to substantive state law (e.g., workers' compensation and motor vehicle accident reparations law), property/casualty insurance markets have an inherently local dimension. The scope of possible gains from centralization is correspondingly limited. Federal chartering would be unlikely to exempt federally chartered insurers from participation in state residual markets, at least initially, given legitimate state interests in ensuring the availability of mandatory coverages. State regulation of residual-market rates might still be used to cap rates for high-risk buyers and produce chronic cross-subsidies, which could lead to extensive litigation between state and federal regulators.

More broadly, the temptation to use insurance regulation to redistribute wealth need not be lower at the federal level. Misguided state regulation is largely unable to achieve subsidies across lines of insurance within a state and across states. Federal regulation might be able to achieve both, especially if redistributive policies are mandated for state and federal insurers. For politically sensitive insurance coverages, federal regulation could ultimately lead to restrictions on rates with harmful effects on private sector risk management and resource allocation. Consumerists already have proposed numerous protections for inclusion in any dual-chartering system. Federal Trade Commission activities, the Home Mortgage Disclosure Act, the Community Reinvestment Act, and congressional hearings on sub-prime ("predatory") lending and credit life insurance suggest that federal insurance regulation would be subject to many of the same pressures that produce state controls on rates and underwriting.

If most insurers could switch charters at relatively low cost, dual chartering could promote regulatory competition and help discipline regulatory excesses. In the short run, dual chartering might provide strong motivation for further state reforms. In the longer run, the ability of federally chartered insurers to switch to state regulation might discourage inefficient federal regulation. On the other hand, as long as the threat of federal regulation is credible, additional gains from actual competition between state and federal regulators may be modest. Moreover, the largely fixed costs of adopting a federal charter will disadvantage smaller insurers, and the cost for multi-state, federally chartered insurers to return to state regulation could be large (larger than in banking), undermining regulatory competition for charters.

Federal guarantee Federal deposit insurance protects depositors of both federal and state banks. A federal guarantee covering the obligations of all insurers could be a precondition for effective regulatory competition on other dimensions. The potential benefits from increased regulatory competition should thus be assessed in relation to any disadvantages of an inclusive federal guaranty program. It is highly probable that

federal guarantees of both federal- and state-chartered insurers would be inevitable with dual chartering, even if initial legislation eschewed federal guarantees and required federally chartered insurers to participate in state guaranty funds or established a federal guaranty system for federal insurers.

A dual-chartering system that would require federally chartered insurers to participate in the state guaranty system without a federal guarantee would be unstable. Insolvency of a federally chartered insurer or a number of state-chartered insurers would create strong pressure for a federal guarantee patterned after deposit insurance. The state guaranty system would likely be seriously weakened without participation of federally chartered insurers. A federal guaranty system would likely expand to cover both federal- and state-chartered insurers.

The danger is that federal guarantees would repeat some of the mistakes of deposit insurance. Specifically, they might inefficiently expand protection of insurance buyers against loss from insurer insolvency (e.g., by reflecting a policy, de facto or de jure, of "too big to fail"). Such expansion would materially undermine incentives for safety and soundness. More regulatory constraints on insurer operations would eventually ensue. The ultimate result of dual chartering would therefore be less reliance on market discipline and more reliance on regulation.

Antitrust Current proposals for dual chartering would substantially eliminate the antitrust exemption for federally chartered insurers. That change could undermine the integrity and value of current systems of information sharing, which would lead to less competition, higher costs of ratemaking, and reduced safety and soundness. Disproportionate effects would befall small insurers, which often play an important role in making coverage widely available. In any case, a transition to optional federal chartering would involve large litigation and frictional costs. Extensive and protracted litigation is likely over the scope of federal pre-emption of state insurance law and permissible cooperative practices for federally chartered insurers.

Conclusion Regulatory policies that interfere with competitive insurance pricing are clearly inefficient; they reduce GDP and consumer welfare. Optional federal chartering might hasten the demise of such policies, but that result is not assured. The unsatisfactory pace of state reforms does not imply that dual chartering would be efficient. The uncertain benefits and large risks of federal chartering favor caution. Although additional state reforms may be slow and sporadic, the trend is in the right direction. **R**

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