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Personal Lines Regulatory Framework

Introduction

An important and controversial topic facing state legislatures is selection of the most appropriate regulatory framework for personal lines insurance products. Making the selection requires careful consideration of many factors. As such, this paper explores choices that a legislature might make along with factors that will influence these choices. This paper also contains a recommendation to the NAIC Property and Casualty Insurance (C) Committee to address the following charge:

> Present a recommendation related to the personal lines regulatory framework to the Property and Casualty Insurance (C) Committee by the 2008 Summer National Meeting so the committee can complete its work on revisions to the NAIC model rating law(s).

To provide a balanced perspective, comments were solicited from parties other than regulators. Comments were received from the American Insurance Association (AIA), the Center for Economic Justice (CEJ), the Consumer Federation of America (CFA), Housing Opportunities Made Equal (HOME), Lawrence Mirel on behalf of State Farm, the National Association of Mutual Insurance Companies (NAMIC), The Property Casualty Insurers Association of America (PCI) and State Farm Insurance Companies.

The paper will concentrate on the two major personal lines insurance products: auto insurance and homeowners insurance. As will be seen, it reflects the opinion of the Personal Lines Market Regulatory Framework (EX) Working Group that the regulatory framework for personal lines insurance products does not need to be uniform in all states.

Historical Perspective

There are three important milestones that add historical perspective to the regulation of insurance products by the states. The first is the United States Supreme Court decision in Paul v. Virginia. In an 1869 decision, the Supreme Court held that insurance was not interstate commerce and, therefore, not subject to control by the federal government under the commerce clause of the Constitution. The second milestone resulted from the 1944 reversal of this decision in the South-Eastern Underwriters case. Following this reversal, insurers, insurer trade associations, insurance producers, rating organizations, state legislators and insurance regulators encouraged Congress to act to avoid drastic changes to insurance regulation. The result was the McCarran-Ferguson Act (Public Law 15-79 of 1945). The third milestone was the reaffirmation of the McCarran-Ferguson Act contained in the 1999 Gramm Leach-Bliley Act.

The McCarran-Ferguson Act provides insurers with a limited exemption from federal anti-trust laws (the Sherman Act, the Clayton Act and the Federal Trade Commission Act) to the extent that insurance is regulated by the states. Federal law still applies to acts of intimidation, coercion, or boycott or allegations of attempted intimidation, coercion, or boycott. Without this limited anti-trust exemption, insurers would not be able to use advisory organizations to collect and compile historical statistical information for ratemaking purposes.

Following the adoption of the McCarran-Ferguson Act, all states enacted laws regulating rates. At the time, there was a great deal of discussion about the topic of this paper. An All-Industry Committee representing nineteen insurer trade associations was formed to work with insurance regulators on a model law. The result was the two "All-Industry" model laws that were adopted by the NAIC in 1946. Minor amendments were made to them in 1947 and they served as the basis for rate regulation in all states. As is typical for NAIC model laws, lobbying efforts by local insurers and their trade associations, local insurance producers and their trade associations and local consumer interests, led to state enactments that were similar, but not identical, to the All-Industry model laws. There were two distinct models at the time - one for fire and marine insurance and one for casualty and surety. This matched the industry custom at the time of having separate entities writing property insurance and liability insurance.

Early rating laws compelled adherence to rates filed by rating bureaus on behalf of their member insurers. Price competition often came in the form of policyholder dividends that occurred after the policy period was over. Some states allowed insurers to file "deviations" from the rates filed on their behalf. The use of dividends and deviations added elements of price competition to the mix.

In the 1960s, a more significant number of regulators and insurers began to question the rate regulatory framework of earlier times. There was a movement in some states to liberalize rating laws to move toward competitively-oriented laws that allowed insurers to adjust their rates to fit the overall economic conditions of the state or area. As long as the rate had a sound actuarial basis, the insurers were allowed to compete for business.

An interesting and significant development occurred in 1972. The rating law in Illinois contained a sunset. A political squabble developed in the Illinois legislature and the legislature adjourned without reaching a compromise on the rating law. The rating law was allowed to sunset, which led to a novel unintended experiment of a state without a rating law or any rate standards for property and casualty insurance products. Although it can no longer be viewed as unintended, Illinois has operated since 1972 without a rating law. This environment led to the development of the market conduct examination and the introduction of the Market Conduct Annual Statement. It should be noted, however, that Illinois continues to review policy forms and reviews rates for unfair trade practices.

Another significant regulatory development occurred in 1988 when voters in California approved Proposition 103 to replace the "open-competition" regulatory framework with prior approval of rates and risk classifications. Some of the most significant provisions of Proposition 103 were limitations on automobile insurance risk classifications, including the requirement that driving record, years of driving experience and miles driven have the greatest weight in determining a consumer's premium – greater weight, for example, than rating territory. Proposition 103 has survived extensive legal challenges.

In the early 1980s, the NAIC adopted model laws containing "file and use" and "use and file" concepts. The "file and use" concept allowed an insurer to introduce rates into the market at the same time they were being filed with the insurance regulator. The "use and file" process allowed the insurer to introduce rates into the marketplace and, at a specified later date, file them with the regulator. Variations between states in the details and the application of such principles were common, however, and these variations make it difficult to group states by their type of rating law and make comparisons.

In the late 1980s, a number of state attorneys general brought legal action against the Insurance Services Office (ISO) alleging its involvement in anticompetitive activities. ISO settled this litigation by changing its corporate structure and going to loss costs in states and for lines where it had not already done so. The NAIC response to this matter included the formation of a working group in January 1989. The working group was charged with the task of reviewing the practice of rating organizations providing fully developed rates, including expense and profit loadings, to their member insurers. By the early 1990s, as a result of this work and of the ISO settlement, a much larger number of states had enacted legislation or adopted regulations or procedures to accommodate and/or require such organizations to file prospective loss costs instead of fully developed rates. At this time "rating organizations" became more widely referred to as "advisory organizations," with the expectation – both by regulators and insurers – that they would now assume even more of an advisory role and should not be allowed to encourage or coordinate concerted action by insurers. Advisory organizations continue to develop loss costs, policy forms and risk classifications that may be used by insurer members of the organizations.

Perspectives of Insurers

During the development of this document, one common theme was apparent from comments received from representatives of the insurance industry. They all encouraged reliance on market forces rather than government officials with regard to the development of insurance products and their corresponding prices. In other words, industry representatives are encouraging state insurance regulators to abandon rate regulation and review of policy form language before policies are sold. With respect to rates, they prefer a system like the Illinois system that has been in place since 1972.

Insurer representatives state that they do not ask for a system without any regulation. They encourage the development of a regulatory framework where regulators monitor insurers for solvency and review insurers' conduct in the marketplace. They seek the same regulatory framework from every state with clear and unambiguous regulatory standards so that they know in advance how their market performance will be measured.

The AIA comments stress four guiding principles that they believe are essential. First is market regulation of rates and policy forms with reliance on consumers to drive marketplace pricing and selection of appropriate coverage forms. Second is for insurance regulators to concentrate on protecting consumers through monitoring financial integrity and market

conduct of insurers. The third AIA principle relates to regulatory uniformity. They stress that regulation should be uniform and

consistent across jurisdictional boundaries. Finally, the AIA asks for clear and unambiguous regulatory standards. In support of its position, AIA cites many academic experts including J. David Cummins, editor of *Deregulating Property Liability Insurance, Restoring Competition and Increasing Market Efficiency*, AEI-Brookings (2002), who wrote: "The time has come to deregulate prices in the personal lines of property-liability insurance. In the long run, price regulation does not result in lower prices for consumers, but it can cause serious economic inefficiencies that destabilize insurance markets and ultimately increase the price of insurance."

According to the AIA, recent developments in risk classification have resulted in more accurate risk assessments, rating systems and underwriting practices that enable many companies to offer coverage to virtually every applicant, assuming no extraordinary catastrophe exposure. The AIA views these more accurate, individually tailored rating and underwriting systems as improvements to older risk classification systems that relied more heavily on larger groupings. The AIA asserts that the result in many markets is fewer assigned risk policyholders, more choices for consumers and lower residual market populations. The AIA notes that these risk classifications are already subject to anti-discrimination laws and are reviewed for compliance with those laws by state insurance departments. According to the AIA, further regulation is neither appropriate under these laws nor would it be beneficial for consumers. The AIA asserts that further limitations would harm good risks by requiring them to pay more than they should, create unfair subsidies for higher risks and reduce competition. It is the AIA's view that such additional regulation would be the opposite of modernization.

The PCI and NAMIC combined efforts and engaged former Illinois Insurance Director Phillip R. O'Connor, Ph.D. to provide comments on their behalf. Mr. O'Connor provided his perspective on insurance underwriting cycles and the laws of supply and demand as they pertain to insurance. He suggested that there is no basis for believing that rate regulation delivers any cognizable benefits to the insurance public. He said that research suggests that reliance on competition and market forces yields benefits to consumers. He points to evidence that the Illinois system works such as low residual market participation, easy access to the market by consumers, high levels of market participation by insurers and little political controversy about insurance. He observes that, on the contrary, anecdotal information concerning turmoil in Massachusetts and New Jersey, when those states had strict rate regulation, is instructive regarding rate regulation.

Mr. O'Connor suggests that the main support for continuing rate regulation comes in three forms: inertia; concerns that reliance on competition devalues insurance regulation; and ideological disposition by some that competition is suspect. He advocates four points for modernizing insurance regulation:

- Presume a competitive market unless proven on a statewide basis to be non-competitive and then any rate intervention should be minimal;

- Findings of non-competition and continued rate intervention should be short-term and requiring justification for extension;

- Policy form standards, if any, should encourage flexibility and innovation while confining restrictions to essential prohibitions or coverage standards; and

- Policy forms could take effect upon filing on the condition that the policy could be found to be non-conforming at any future time and subjected to withdrawal and/or interpretation in a conforming manner.

State Farm maintains that the market in the United States for personal auto and homeowners is intensely competitive. It maintains that there are a large number of firms selling similar products and that seller concentration is relatively low. It adds that market entry is relatively easy and that there is significant price competition. State Farm encourages enactment of rating laws that rely on competition to assure reasonable prices rather than on laws requiring regulatory approval of rate changes and oversight of the details of ratemaking. It encourages the adoption by all states of an Illinois-style rating law. It believes that rate review and approval systems impede competition, thereby harming consumers and giving rise to calls for federal legislation to preempt state insurance rate regulation. It also suggests that the NAIC endorse the elimination of policy form filing requirements. It believes that a self-certification system like that employed in Colorado would be sufficient to protect insurance consumers.

State Farm hired former District of Columbia Insurance Commissioner Larry Mirel to supplement its comments. Mr. Mirel provided evidence and cited several studies to answer two basic questions. First, do rating laws keep consumer prices down?

Second, does the partial exemption of insurers from federal anti-trust laws result in market restriction or price collusion? Mr. Mirel's answer to both questions was no. He encouraged the working group to look at the fundamental question of whether regulators should be in the business of setting or controlling prices for personal lines products. He suggested that absent a strong case that price regulation is necessary to protect consumers and that purchasers of insurance are better off in jurisdictions that control prices, the NAIC should favor the repeal of rating laws.

Perspectives of Consumer Representatives

Consumer representatives have a different view on the regulation of rates and policy form language. They maintain that market forces alone are insufficient to prevent market failures. They point out that the fact that state legislatures routinely enact legislation to restrict insurers' activities regarding pricing and policy form content is evidence that state legislatures do not believe that deregulation will protect consumers from market abuses.

The CEJ and the CFA combined efforts to submit their comments. The CEJ and the CFA encourage the avoidance of euphemisms such as modernization or efficiency when what is sought is deregulation. They encourage the return of the insurance mechanism to its two essential public policy roles—providing businesses and families with essential financial security tools and promoting loss prevention. They warn regulators that techniques commonly used to monitor competition are likely to miss market failures that arise when specific market niches are less likely to be offered quality coverage and/or are being unfairly discriminated against in pricing.

The CEJ and the CFA encourage regulators to analyze personal lines insurance markets as three separate frameworks within an overall framework. They suggest that separate regulatory frameworks be established for policy forms, risk classification and overall rate level. They suggest promulgation of standard policy language for auto and home insurance products to provide a standard product for consumers that allows them to evaluate the product based on the price they are quoted by the insurer without trying to evaluate nuances in coverage levels. Endorsements would be subject to prior approval with a 30-day deemer provision and authority to withdraw approval on prospective basis. They suggest a rigorous review framework for risk classifications. They suggest that the regulator promulgate a list of risk classifications that are required, permitted and prohibited. Other risk classifications that an insurer wished to use would be subject to prior approval with specified criteria in the law. For overall rate level changes, the CEJ and the CFA suggest a file and use system with very limited circumstances where a regulator would have authority to disapprove a filed rate. They suggest that regulators address the blurring of underwriting and rating caused by rating tiers and also encourage regulators to address the issue of regulation of third-party vendors.

The CEJ and the CFA believe that regulators and insurers should be actively involved in promoting beneficial competition. They suggest that states maintain up-to-date web-based price comparisons to help consumers shop for coverage. They suggest that the use of advisory organizations be prohibited and that anti-trust provisions be fully applied to insurers. They argue that promulgation of standardized policy forms by advisory organizations hinders competition, while promulgation of standardized forms by the regulator would promote competition. They encourage the regulator to collect and publish market performance data on insurers in a manner comparable to that contained in the Home Mortgage Disclosure Act.

Consumer advocates have expressed concern that a recommendation for deregulation – couched in terms of moving towards greater reliance on "competition" – would lead to the elimination of critical regulatory protections for consumers. Consumer advocates do not believe that deregulation or unfettered risk classification has benefited most consumers and point to states that have moved to more stringent regulation because of concerns over "open competition." Consumer advocates do not think that personal lines markets are sufficiently competitive to allow market forces to be the sole protection for consumers. They point to recent market disruptions in property insurance markets along the eastern and southern coasts as examples.

HOME suggests that insurers are not adequately serving all insurance markets. HOME maintains that the use of certain underwriting guidelines and other market practices combine to create a new form of redlining where the poor, urban residents and people of color are not well served by the insurance industry. HOME suggests that the regulators abandon the notion of determining whether competition exists, as there is not a single marketplace, but many sub-markets within a state

or line of business. HOME suggests that insurers be required to provide regulators with data similar to that set forth in the Community Reinvestment Modernization Act of 2001. HOME also encourages publication of the data in a user-friendly form to help consumers, regulators and the industry address market failures. HOME suggests periodic market audits using paired testing to evaluate access to insurance products. HOME agrees that regulatory promulgation of common policy language would make it easier for consumers to shop for insurance. They also suggest periodic evaluation of risk classification factors for disparate impact on protected groups.

Competitive Markets and the Economics of Regulation

To evaluate the prior research regarding competitive markets and the economics of insurance, the Working Group received recommendations regarding a number of academic studies from interested parties. It is important to note that there are studies that support either greater or complete reliance on competitive market forces as the best "regulator" of prices and those that support various forms of price regulation. In forming its opinion regarding appropriate regulatory framework, depending upon characteristics of the market under consideration, the Working Group considered a variety of approaches.

The main function of a market, whether highly competitive or highly regulated, is to facilitate the most efficient exchange of goods and services. This is true of insurance markets as well. According to economic theory, a market-driven insurance industry should provide "an efficient allocation of society's scarce resources" while maximizing consumer choice and value.[1] If significant imperfections do not exist, a competitive market will require no governmental intervention or oversight. Market forces themselves are a form of regulation in that they instill price, market conduct and other disciplinary forces upon industry participants.

Though markets often "self-regulate," there can also be undesirable side-effects within markets. Policymakers sometimes enact regulations in an attempt to lessen the effect of any undesirable outcomes from market operations. Inefficiencies within markets often lead to governments taking regulatory actions in order to address market instability and uncertainty. Inefficiencies may include extreme situations where firms attempt to eliminate competitors and control the market or less dire situations where markets exhibit failures or imperfections.[2] It is these situations, where markets do not provide the most efficient allocation of resources, which lead to regulation of industries.

When consumers hear the term "regulation" their natural thought process often brings them to think of some sort of government agency overseeing certain aspects of industry. The actions most typically thought of by consumers are price (rate) regulation and consumer protection (market conduct) regulation. Economic regulation can involve government-imposed restrictions on price, quantity, and entry and exit.[3] Government interaction affects market behavior in an attempt to improve market functionalities but market forces continue to play a significant role.

Regulatory frameworks based heavily or solely upon a reliance on competition (e.g., anti-trust laws) will take direct steps to assure that no one competitor is allowed to obtain too much market share, at least not through the acquisition of competitors, agreements to allocate markets or pricing below cost to drive competitors from the market. While insurance regulation recognizes these possibilities to a certain extent, the original justification for insurance rate regulation was developed in large part from a desire to allow cooperative action among entities that were otherwise competitors, which is something that traditional anti-trust frameworks also prohibit. In fact, while there is still a desire by regulators to allow certain specific, limited forms of cooperative action (e.g., data collection and certain residual market activities) -- and allowance of these activities necessitates at least a certain degree of regulatory oversight -- rate regulation today is more reasonably justified because markets fall short of "perfect competition" in ways other than collusion or excessive concentration. While insurance-related examples of excessive market concentration exist and have existed in some commercial lines (e.g., medical professional liability), they have not been observed for homeowners or private passenger automobile on a statewide basis, and free entry appears to make such unhealthy concentrations unlikely even for niches of these markets. As such, in present personal lines markets, while excessive market concentration is generally not viewed as a material impediment to competition, laws to deal with a monopoly or oligopoly are something that should be available to

[1] Skipper, Harold and Klein, Robert. (2000) "Insurance Regulation in the Public Interest: The Path Towards Solvent, Competitive Markets," *The Geneva Papers on Risk and Insurance*, vol 25, no 4, p. 488.
[2] McDowell, Banks. (1989) *Deregulation and Competition in the Insurance Industry*. New York: Quorum Books, p. 95.
[3] Viscusi, W., Vernon, J., and Harrington, J. (1995) *The Economics of Regulation and Antitrust*. Cambridge: MIT Press, p. 807.

regulators in case such situations should ever threaten.

Most, if not all, industries throughout modern history have experienced governmental regulation to some degree. All businesses are subject to numerous regulations concerning product safety laws, employment laws, community zoning regulations, and accounting practices and procedures that ultimately have an impact on the cost of goods and services. For instance, while the production of food is thought of as a competitive market, producers and suppliers are bound by numerous safety regulations designed to keep the food supply safe. In addition, the government has created numerous agricultural subsidy schemes, in some cases, to cap food prices and, in others, to create a price floor. The utility, telecommunication, and transportation industries have experienced the highest degree of governmental regulation in the United States, particularly as a result of their importance to trade and commerce. Many other industries have been left, more or less, to competitive market forces with minimal government intervention.

In any case, governmental involvement occurs in all industries with its function, in most cases, to provide a market structure for all competitors – creating a rule book for competitors to play by. Typically regulation is seen as providing a structure or framework to encourage competition, rather than enacting strict control of prices or inputs that could impede competitive forces even further. Economists agree that governments should attempt to "craft laws and enforce regulations that promote more transparent markets supported by fair competition unfettered by government direction, favoritism, and unwarranted interference."[4] The regulator should not typically oversee price and input decisions but "establish policies that assure that the conditions for contestability—free entry, costless exit, and slow price response by the incumbent [to market conditions]—are met as closely as possible."[5] Government regulation should focus on "fairness, nondiscrimination, consumer protection, and quality maintenance."[6] Economists agree that free markets, with few exceptions, allocate resources most efficiently. This implies that regulations should strive to eliminate or reduce any imperfections that might exist, so as to enhance market efficiency, not to impede the functioning of an efficient market.

Competition tends to encourage innovation and lower prices. Market failures sometimes occur when certain competitive conditions are not met. Demand for regulations often arises, in large part, due to a perceived lack of a competitive environment within an industry. Regulatory actions should be taken where competitive forces are lacking in an attempt to make markets more competitive.[7] Economists argue that the proper role of regulation is to promote and/or monitor competition rather than setting prices or controlling inputs. To the extent that government regulation is warranted, it should be designed to provide policies that instill competitive market characteristics when they are absent from the market or are ineffective.

The insurance industry, as noted previously, has a long history of regulation in the United States which has developed as a result of market failures, either real or perceived. While each state implements its own insurance regulatory system with various degrees of regulation, they all have similar regulatory goals. One goal of insurance regulation is the avoidance of insolvencies. This goal is not critical in other industries because consumers are not typically dependent upon a firm's financial stability years after the initial purchase. A free market allows firms to dissolve which leads to greater market efficiencies. However, in the insurance industry, regulators attempt to protect consumers by reducing the number of insolvencies and limiting their harm. The other primary goal of insurance regulation is to protect consumers from harm that may occur in the market conduct of insurers including claims practices and pricing.[8] An overarching goal for the insurance market is that "quality, reasonably priced products are available from reliable insurers."[9] The role of regulators is to protect the public by seeing to it that fair competition exists to achieve these goals while protecting buyers from anticompetitive or unfair practices. The main disagreements over regulations arise regarding at what point and to what degree regulatory actions are needed in certain locales and situations and what nature those actions should take.

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[4] Skipper and Klein (2000, p. 504).
[5] Train, Kenneth. (1991) *Optimal Regulation: The Economic Theory of Natural Monopoly*. Cambridge, MA: The MIT Press, p. 306.
[6] McDowell, Banks. (1989, p. 8).
[7] Skipper and Klein (2000, p. 482).
[8] Hanson, Jon S., Dineen, Robert E., and Johnson, Michael B. (1974) *Monitoring Competition: A Means of Regulating the Property and Liability Insurance Business*. Milwaukee, WI: National Association of Insurance Commissioners, p. 674.
[9] Skipper and Klein (2000, p. 495).

Conditions for a Competitive Market

Although rare, uncompetitive markets can exist in the form of monopolies or oligopolies. More frequently, market deficiencies arise from imperfect information, which may lead to the inaccurate estimation of expected losses and may cause insurers to overreact to unexpected or severe events. Market deficiencies (e.g., in the form of cyclical markets or steep price hikes) may arise because insurers and investors move slowly in response to markets that are either short on capacity or that have become competitive to the point that profitability is difficult. As we shall discuss, several important market characteristics must be present in order for a market to function efficiently. These characteristics of efficient markets are common assumptions found in economic models of perfect competition. Economists recognize that, in reality, what exists rather than this "perfect" ideal is a reasonably efficient market that lacks material deficiencies and where government intervention will not lead to a more efficient outcome.

One characteristic of a competitive market is the presence of a large number of buyers and sellers in the market, none of which has the ability to set prices. On the supply side, numerous sellers in the market will put downward pressure on prices and reduce marginal profits (additional profit gained for every additional good or service sold) as businesses compete. On the demand side, numerous buyers in the market will mean that they do not have the ability to negotiate the price below the cost of the seller to provide the good or service. The insurance industry cannot be analyzed as a monolithic whole but should be analyzed on a specific line and geographic market basis. Overall, there are many insurance writers and little concentration in the U.S. market. However, each individual line of business should be looked at individually and in a geographic region, whether a state or smaller area, in order to measure the concentration and competitiveness of an insurance market.

The ease of entry into and exit from the market by both buyers and sellers is another market characteristic that is prevalent in competitive models. From the supply side, it is a common misunderstanding that freedom of entry into and exit from markets means that sellers are able to do so without any financial barriers. Much of the research done on this issue regarding the insurance industry assumes that this means insurers have transaction costs related to licensing requirements, solvency standards and the distribution system. Yet it is equally important that free entry incorporates the idea that a new entrant is not at a cost disadvantage compared to an existing firm when entering a market.[10] For insurance, this also means that new entries do not have a difference in the cost and availability of loss cost data. Bureau rates were once the answer to solving this problem. Insurance rate organizations can help to promote competition by allowing smaller or new insurers to have access to information that lowers their cost of ratemaking. As bureau rates have been reduced in importance in most states, insurers have developed the ability to develop their own loss cost data for personal lines. This may also partially explain the price variation that tends to occur in personal lines insurance. However, in many instances smaller companies will either use the bureau rates or the rates of the market leaders as a guide to developing their own rates. Where this is prevalent, there may not be much of an impact on market price variation.

On the demand side of some insurance markets, buyers cannot leave the market because of mandatory liability laws for auto and property insurance requirements by lenders. Most consumers are also constrained by the lack of substitute goods for insurance. On the supply side, the ability of insurers to enter and exit markets is restricted by cancellation and nonrenewal laws, capital and surplus requirements, and certain other entry and exit restrictions contained in state laws.

Competitive market theories also assume that both firms and consumers have all relevant information available to them about the good or service offered. There has been a significant amount of academic research on information as it relates to competitive markets. Economists have stated that “the greater the degree to which the insurance buying public is informed concerning the nature and the price of the insurance product, the greater is the likelihood that workable competition exists.”[11] Consumers should have knowledge of price differences as well as differences in the product’s quality and service.

Lack of product information and its impact on consumers in insurance has been well documented. Insufficient consumer knowledge is often a significant obstacle to competition in insurance markets. Some observers attribute regulatory financial oversight of insurers to the fact that there is an information imbalance between insurers and consumers. Even if consumers were interested in finding out for themselves the financial stability of an insurance company, they likely would lack the ability to properly do so. State insurance departments have taken over this role for consumers through their

[10] Train (1991, p. 303).
[11] Hanson, Dineen and Johnson (1974, p. 695).

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continual analysis of the financial solvency of insurers.

Because personal lines insurance products are complex, it is not clear if consumers have sufficient, relevant information to make good insurance-buying decisions or that consumers feel it to be a worthwhile expenditure of their time to digest the information that is available. In fact, studies have found consumer understanding of insurance disclosures to be limited. Recent NAIC research also indicates consumers have limited understanding of policy coverages. There are significant differences in the coverage provided by insurers' policy forms, but information about policy provisions is often difficult to obtain. Insurers' advertising generally does not focus on these differences, and state regulators have usually not felt it to be an efficient use of their limited resources to produce policy form comparisons for the public. With respect to rates, the Internet now gives consumers easier access to price quotes and additional data concerning available coverages, although the utility, user-friendliness and effectiveness of Internet-based quoting systems are still in need of regulatory study to determine the degree to which they cause competitive market assumptions to be met. Price shopping is complicated by issues associated with the consumer's need to renew the insurance policy, or find a new one, at regular intervals, and by tie-ins such as multi-policy discounts. For example, a consumer who purchases a new auto insurance policy from a different insurer, based on the price of auto insurance, might not realize that he or she just lost a multi-policy discount on his or her homeowners insurance policy, or the consumer might switch auto insurers without realizing that in another six months he or she would have received a three-year claim-free discount on the previous auto insurance policy. Given the increasing complexity of insurers' rating systems—including credit scoring and tiering rules—even a state insurance department has difficulty compiling meaningful rate comparisons.

An inability of consumers to effectively comparison shop for insurance products may be justification for greater requirements for information disclosure. Regulators have attempted to lessen the information asymmetry that exists between insurance buyers and sellers by mandating certain disclosures, reviewing insurer rates and rating systems, monitoring insurers' financial condition, regulating market conduct practices of insurers and providing information and education to consumers.[12] A key role of regulators is in helping consumers with the insurance buying process by providing information on the insurer's financial condition and the benefits and nature of the insurance products. Consumers are able to obtain adequate pricing data from insurance agents but this is time consuming and somewhat inconvenient. Valid, meaningful and well-explained pricing data available on the Internet would alleviate some of these information problems.

Proponents of a more regulated environment note that while the information available to the public is better now than it ever has been, there remains significant information asymmetry in personal lines markets. One recent example of this is the significant number of homeowners who think flood is a covered peril in standard homeowners policies.[13] Yet the mere fact that consumers may lack information is not proof of a market failure if the information is readily available but consumers choose not to obtain it. In these instances, additional educational efforts by regulators or consumer groups may be desirable in order to reach consumers more effectively.

In addition, the fact that insurance is a complicated product does not necessarily call for greater regulation, as numerous products from computers to automobiles are complicated in their design, manufacturing and engineering. With many products, consumer groups provide buyers guides and detailed reviews of the product. This occurs to some extent with insurance products, and some consumer groups have recently called for greater disclosure of data related to insurers' conduct in the marketplace.

The Importance of Aggregate Consumer Demand in Insurance Markets

An essential element to consider when looking at competitiveness in markets is that of inter- vs. intra-industry competition. Intra-industry competition – market competition among insurers – has been the primary source of competition studies undertaken in the insurance academic literature. Little, if any, research has been done on inter-industry competition in insurance. Inter-industry competition involves the idea that consumers do not have substitute goods for insurance and can be "captured" by suppliers. For regulated industries, inter-industry competition can be of more significance than intra-industry competition. This distinction is critical to the insurance market. While consumers may have several choices from whom they can buy personal lines insurance, for all but a wealthy few, there are no alternatives to insurance.

Because of the mandatory or near-mandatory purchase and limited available substitutes, it is possible that aggregate

[12] Skipper and Klein (2000, p. 490).
[13] NAIC Press Release; *What Isn't Covered by your Homeowners Insurance?* June 4, 2007.

demand for personal lines insurance does not exhibit the traditional downward-sloping linear demand curve that is assumed in economic models of competition. The result may be an inelastic demand curve, at least in the relevant market range. An inelastic demand curve is one in which the quantity demanded by buyers is relatively unresponsive to a price change. Consumers exhibit relatively inelastic demand curves when demand is great and no alternative sources of supply or substitutes are available.

It is more likely that personal lines aggregate demand is a kinked demand curve, where at a certain (high) price point, most consumers would choose not to purchase insurance coverage regardless of requirements to do so. At the other end of the curve, most consumers would purchase insurance because of the real or perceived economic benefits of doing so. Appendix A provides a description of the kinked demand curve concept as it applies to personal lines insurance. What is important to understand is that when the aggregate demand function is inelastic, market forces will put upward pressure on prices so that the firms' total revenue is maximized and marginal revenue equals zero. The additional revenue that would be gained by adding new customers would not be sufficient to compensate for the decreased revenue from reducing prices to gain new customers. In fact, the inelastic demand concept is commonly found in regulated markets. It then becomes a matter of public policy as to whether a market equilibrium is socially acceptable. If at this point industry marginal profit (marginal revenue – marginal cost) equals zero, then price regulation to lower rates cannot create a net welfare gain.

Under the kinked demand concept, it would be expected that competitive markets would, on average, exhibit higher prices and higher profits than markets in regulated states. While research on such a concept in insurance is not available, there exists a body of research on price differentials and industry profits between regulated (stringent regulation such as prior approval) and competitive rate regulation (non-regulated) states. The results of these studies have been mixed, with some finding lower premium rates in regulated states[14], others finding higher rates in regulated states[15] and some finding no significant evidence of rate differentials.[16]

The body of academic research regarding insurance market competitiveness focuses nearly exclusively on examining whether there is competition on the supply side of the equations and either ignores the impact of aggregate demand of the model or assumes that aggregate demand is a normal, downward-sloping demand function. Consumer demand curves are based upon consumers maximizing satisfaction through their tastes, prices of the good and other goods, and income.[17] In the cases of automobile and homeowners insurance, where such coverage for many people is a compulsory purchase, it is possible that an efficient market-clearing price may not be able to be established in a competitive free market because consumers are required to purchase the insurance, have no other product offerings to consider and in many cases are not able to effectively consider the price of the insurance product because of incomplete information about the insurance product.

The existence of a kinked demand curve may exist within other industries as there are other products that are near-necessities. Education and automobiles are near-necessities and health care and food are absolute necessities. The extent of substitutes for these goods can be debated and the proper distribution system varies for these goods. For instance, vehicles may be best served in an unregulated market while education and health care may work best in a regulated or government-controlled market. If a market cannot efficiently provide near-necessities, there is a continuum of possible options available to deal with this shortcoming, such as charities, vouchers, subsidies or government control of prices or inputs. All of these options should be explored in order to determine the most efficient allocation of resources.

In addition, although some insurance products are mandated purchases for some consumers, we do not know the degree to which consumers would buy the insurance products on their own. One example of consumers not buying an insurance product is with renters insurance but it is not known whether consumers do not buy the product because they do not wish

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[14] Tennyson, Sharon. (1997) "The Impact of Rate Regulation on State Automobile Insurance Markets," *Journal of Insurance Regulation*, Vol. 15, no. 4; Suponcic, S.J. and Tennyson, S. (1998) "Rate Regulation and the Industrial Organization of Automobile Insurance," in David Bradford, ed., *The Economics of Property-Casualty Insurance*. Chicago: University of Chicago Press; Cummins, J.D., Phillips, R. and Tennyson, S. (2001) "Regulation, Political Influence and the Price of Automobile Insurance," *Journal of Insurance Regulation* 20 (1): 9–50.
[15] Choi, P. B., Weiss, M. A. (2005) "An Empirical Investigation of Market Structure, Efficiency, and Performance in Property-Liability Insurance," *Journal of Risk and Insurance* 72 (4), 635–673.
[16] Ippolito, R. (1979) "The Effects of Price Regulation in the Automobile Insurance Industry," *Journal of Law and Economics* 22 (1): 55–89.
[17] Hanson, Dineen and Johnson (1974, p. 112).

to or because they believe they are covered under another policy, such as the building owner's policy. Flood insurance is also not frequently purchased. It is not intuitive whether the mandatory purchase of an insurance policy, such as flood insurance, would fundamentally change the demand curve and require regulation. It does seem likely that most consumers would probably purchase at least basic homeowners and automobile insurance even if not required to do so. Also, most consumers purchase more than the minimum mandated amounts when required to buy insurance. Consumers have a desire to protect their assets regardless of any mandate to purchase insurance. This fact calls into question the existence and effect of the kinked demand curve. More research would need to be done on consumer preferences and the nature of consumer demand for insurance in order to develop a more precise model of the kinked demand curve.

Social Welfare Aspects of Personal Lines Insurance

There are some important considerations regulators must be aware of in order to understand the appropriate market structure, particularly when the competitive assumptions discussed previously are not completely present. A key result of efficient competitive markets is that the efficient exchange of goods and services is established and neither buyers nor sellers can be made better off without making the other party worse off. If one of the competitive assumptions is violated, there is likely a way to make some consumers better off without harming others.[18]

Insurance fills a unique societal role by not only protecting the purchasing consumer from financial ruin but also protecting other drivers in the event of an auto accident or, in the case of homeowners insurance, protecting the community as a whole in the event of a widespread catastrophic event. The importance of insurance and its role to society is clear. For these reasons regulators are cognizant of balancing the social good that is insurance with the goals of profit-maximizing insurers. Oftentimes, profit-maximization and the social good are at odds. Within certain geographical areas, or sometimes for policyholders with characteristics correlated with higher risk of loss, high prices and low availability may call the existence of a vibrant, competitive market into question. These situations present challenges to regulators who, like consumers and insurers, desire a market that is properly functioning. A properly functioning market will be characterized by widespread availability and, to the extent that higher losses and/or lower policyholder income make standard insurance products difficult to afford, the marketplace will respond with fairly priced products designed to provide more basic, yet still sufficient and appropriate coverage. An example of such a product might be a private passenger auto policy with reduced premiums for policyholders with very low annual mileage.

As seen above, competitive market theory holds that consumers have the relevant information necessary to purchase an appropriate product at a competitive price, including the decision not to purchase a good or service or to purchase a complementary good or service. Another wrinkle is added to this when – as is often the case with personal lines – insurance purchases are compulsory. Regulators must determine whether they should remain involved in an otherwise competitive market where consumers essentially have no alternative but to purchase a good or service. Additionally, if a large percentage of consumers fail to obtain or adequately comprehend information to identify and compare appropriate insurance products, then the question arises as to whether regulators should compensate for this by examining underwriting criteria, subjecting rates to filing and/or approval requirements, or by monitoring competitive activities of companies in the market. Thus, as minimizing the role of regulators is generally deemed to be desirable, the insurance industry should expect a less-intrusive regulatory approach to require insurers to share this information with consumers and other firms in the market in order to avoid market failures. Given the reluctance or inability of individual consumers to adequately digest detailed technical information, the challenge is to identify effective ways to communicate this information that require a minimum of government supervision and intrusion.

Regulators play an important role in balancing sound public policy with the interests of a profit-maximizing industry. Economists in general have recognized that, in imperfect markets, regulation can improve the overall welfare of consumers.[19] Yet they also warn that regulators should not unnecessarily intervene in competitive markets and should recognize that economic theory states that a competitive market will lead to efficient outcomes, including low prices, reasonable profits and innovative products. However, within the insurance industry, there seem to be localized situations, particularly involving catastrophic situations and regions, where the market has not been well served. These specific instances, rather than the general idea of rate regulation, deserve the most research and attention.

[18] Hanson, Dineen and Johnson (1974, p. 132).
[19] Viscusi, Vernon and Harrington (1995, p. 528).

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Rate Regulation vs. Price Control

There has been much rhetoric about state regulators engaging in price control. This characterization appears in recent Congressional testimony and is contained in the comments of insurance industry representatives to this Working Group. The use of this characterization leaves the uninformed with the impression that most or all states set insurance rates for insurers. In recent years, all states have moved away from the strict setting of rates. Rather, insurers develop the rates and rating systems that they intend to use and, in most states, file that information with the insurance regulator. Over time many states have moved away from prior approval regulatory frameworks toward those that place greater reliance on competitive forces. At the time this was written, there were 19 states that still operate under a prior approval framework. One of the 19 prior approval states (Georgia) is prior approval for auto insurance while employing a file and use system for homeowners. Thus there are 31 jurisdictions that currently embrace some form of flexible or competitive rating for personal lines products.

However, a two- or three-word description of a state's rating law (such as prior approval or file and use) does not always tell the whole story. In many jurisdictions the regulator has some measure of discretion as to how the regulatory framework is administered. For example, a file and use system can be administered – or treated by insurers - in a way that is not very different from a prior approval system. In flex-rating states, prior approval may apply only if a rate request involves a relatively large increase.

Recommendations to the Property and Casualty Insurance Committee

The NAIC was formed to provide a forum for development of uniform policy when uniformity is appropriate. There is no single national auto insurance market or homeowners market in the United States. The Working Group recognizes that the unique characteristics of an individual state's market may call for differences in regulatory frameworks. In recognition of the unique exposures to loss faced by different states, the unique legal frameworks (e.g. tort v. no-fault) and market conditions, this document contains some recommendations for actions by the NAIC and a set of principles that states can use in evaluating their current regulatory framework for personal lines insurance products. These principles can be used to help public policymakers evaluate current market performance and determine if changes are needed to the regulatory framework that either increase or decrease reliance on competitive forces. National uniformity is not necessary.

The Working Group recommends:

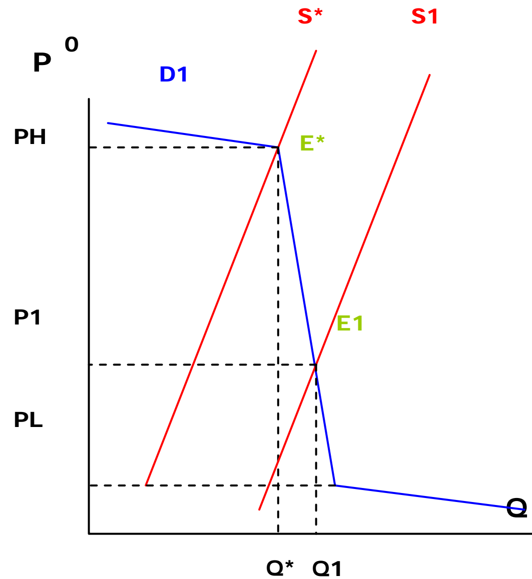
- That model laws #775 and #780 and the 2000 draft model law and regulation be identified as guidelines and retained as a resource. The Working Group believes that the consistency of language for the various approaches to developing a regulatory framework for property and casualty insurance products would be beneficial to legislators as they develop statutory changes.

- That the Committee examine the effects of data mining and the resultant detailed risk classifications now being used for underwriting, tier placement and rating. This examination should consider these effects on both availability and affordability of insurance for lower-income policyholders as well as policyholders generally.

- That the Committee recommend that states consider whether market conditions within their jurisdictions might be favorable for a movement toward a more competitive regulatory framework, beginning with steps such as flex-rating (if that is a movement to more competition from a prior approval law, for example). States with markets exhibiting less than adequate degrees of competition should consider ways to address their problems so that market forces can be used as the regulator of prices to the greatest extent possible. States should use the least intrusive-to-the-market regulatory framework consistent with consumer protection.

Appendix A

Discussion of Aggregate Demand Function for Personal Lines Insurance



Personal lines insurance can be characterized by a kinked market demand curve as a result of externalities created from compulsory purchase requirements (either by statute for auto liability or imposed by finance company requirements in home and auto physical damage) and the unavailability of substitute goods for nearly all consumers. The first portion of the market demand curve, D1, says that at some price (> PH), most consumers will decide to 'go bare' and not purchase insurance at higher prices. On the other end of the kinked demand curve, at some price (< PL), most consumers will decide to purchase insurance because they perceive the cost of insurance coverage to be negligible relative to their risk. The demand curve between points PH and PL, the relevant portion of the demand curve for insurance markets, denotes a relatively inelastic market demand for insurance coverage reflecting the fact that consumer are required to purchase insurance whether they want to or not and, in most cases, do not have an alternative product or products to consider other than personal lines insurance.

With this kinked demand curve, the optimal supply curve for the insurance industry is characterized by S*, with an optimal amount of insurance Q* at a market price of PH. In this market (regardless of regulation) there is no incentive for the insurance industry to expand their market capacity (an outward shift of the industry supply curve to S1) beyond this level. Such an outward shift on the inelastic portion of the demand curve would yield a modest gain in new customers or increased insurance coverage (Q* to Q1), but at a large decrease in price (PH to P1). Such a small increase in new business in the market would not compensate for the relatively large decrease in price since total revenue is maximized (as measured by the area of 0,PH,E*,Q*). At point E*, marginal revenue for sellers equals 0. As a result of the inelasticity of demand, market forces will result in an inefficient allocation of resources as buyers, in the aggregate, are unable to exert sufficient market pressure on suppliers to lower prices and no market incentives exist for insurers to prove additional coverage.

Appendix B

Personal Lines Insurance Products as Commodities

Insurance industry representatives seem to make an underlying assumption that personal auto and homeowners insurance products have evolved into commodities that are just like other products consumers buy. In this section, we examine that assumption with a comparison between insurance products and other products available to consumers.

There are important distinctions that make insurance different from other products. One should note that if the suggestions by the consumer representatives are adopted to standardize the policy language of auto and homeowners contracts, insurance would be more like other commodities that consumers purchase.

In the following chart, we compare common products that consumers buy.

COMPARISON OF COMMON PRODUCTS				
	INSURANCE	MORTGAGES	HARDWARE	AUTOMOBILES
Wholesale Cost	Unknown at time of sale. Expected cost varies widely, based on buyer characteristics	Variable over the period of the loan	Known to manufacturer	Known to manufacturer
Retail Price	Specific price quotes available; difficult for the public to comparison shop	Loan rates published and specific quotes available	Publicly advertised	Publicly advertised
Price Regulation	Regulation varies by state and addresses lack of information and complexity for consumers	Current interest rates published and not regulated for price	Market regulates prices	Market regulates prices, however manufacturers required to include many safety features
Limitations	Some people might only be eligible for limited forms of coverage	Some people might only be eligible for higher interest rate loans	No Limitations	No Limitations
Access	Available to all who meet underwriting standards	Available to all who meet underwriting standards	Available to all who can afford cash or credit	Available to all who can afford cash or credit
Transparency	Underwriting standards generally unavailable to the public	Underwriting standards available to the public on request	Prices clearly marked on items	Prices marked, but often willing to negotiate
Suitability	Consumer generally can only determine suitability after a claim occurs	Consumer has limited time period to reconsider decision	Can return to retailer if unsuitable; some warranties apply	Warranty provided for a specified time period
Finality of the Transaction	An agent can bind coverage and an underwriter might decide that the person is ineligible and cancel the policy on a prospective basis	The underwriting decision is made before a mortgage is granted	The hardware item belongs to the consumer once it is purchased, unless it is defective and returned at the consumer's option	The automobile belongs to the consumer once it is purchased, unless a lemon law applies and returned at the consumer's option

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COMPARISON OF COMMON PRODUCTS				
Compulsion to Buy	Personal lines insurance products are essential – Auto because governments require – Homeowners because lenders require	Have option to rent or pay cash for a dwelling	Optional	Essential unless public transit is available. Not compulsory
Availability of Market Data	Limited market data availability	Current interest rates published and advertised. Market performance data collected by HUD.		Much consumer safety and comparative performance data is available to the public.

Appendix C

Continuum of Rate Regulatory Frameworks

The Working Group has studied the various systems in use in the states and offers the following continuum of regulatory frameworks (for types of rating laws) for rates, forms and risk classifications. The various systems as applied to rates and risk classifications are briefly described in the following chart. The chart is assembled with the most restrictive framework first and descending to the least restrictive framework.

TYPES OF RATING LAWS

FRAMEWORK	DESCRIPTION
State Mandated Rates	Rates determined by the insurance regulator. Insurers must use the rate or may file a deviation to charge a rate below the published rate.
Prior Approval	Rates must be filed with and approved by the insurance regulator before they can be used.
Flex Rating	Prior approval of rates required only if they exceed a certain percentage above (and sometimes below) the previously filed rates, otherwise a file and use provision applies.
File and Use (Waiting Period)	Rates must be filed with the insurance regulator prior to their use. A waiting period applies before the rates can be used. Specific approval is not required but the department retains the right of subsequent disapproval.
File and Use (No Waiting Period)	Rates must be filed with the insurance regulator prior to their use. The rates may be used immediately. Specific approval is not required but the department retains the right of subsequent disapproval.
Use and File	Rates must be filed with the insurance regulator within a specified period after they have been placed in use.
Informational File	Rates must be filed with the insurance regulator for informational purposes. No formal review of them occurs and no supporting documentation is required.
No File	Rates are not required to be filed with or approved by the insurance regulator. However, the company must maintain records of experience and other information used in developing the rates and make these available to the commissioner upon his request.

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