

Public Policy and Property–Liability Insurance

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The property–liability insurance industry has experienced significant turmoil during the past decade. Three related issues have received enormous attention: increases in the frequency and severity of insurance company insolvencies, high and increasing costs of automobile and workers' compensation coverage, and volatility in prices and in availability of commercial liability insurance coverage. These phenomena have led to considerable debate over the efficacy of state insurance regulation and the industry's limited exemption from antitrust law. Much of the policy debate concerns whether federal regulation of insurance company solvency, expansion of state regulatory control over insurance pricing, and narrowing or elimination of the exemption from antitrust law are needed to deal adequately with these problems.

This paper addresses solvency regulation, rate regulation, and the antitrust exemption for the property–liability insurance industry. In each case, it first briefly reviews rationales for government action to enhance economic efficiency. Then it will discuss regulation in practice and whether proposed changes will enhance efficiency. The discussion suggests three conclusions. First, the case for substantive federal intervention in solvency regulation is not compelling, and federal intervention could ultimately lead to an increase in the total cost of insolvency. Second, state regulatory control of insurance pricing is inefficient. Rather than expanding state regulation, efficiency would be better served by deregulation of rates. Third, substantial change in the industry's antitrust exemption will not alleviate market problems. It

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could aggravate these problems, and it definitely would require a costly period of adjustment.

Solvency Regulation

Insolvency risk for property-liability insurers arises from uncertainty over both the magnitude of liabilities for claim payments and the return on assets purchased with investor capital and premiums. The value of insurer net worth also may fluctuate with changes in interest rates. Finally, up-front payment of premiums and deferred payment of claims create a significant risk of fraud and opportunistic behavior by insurers.

Rationales for Solvency Regulation

In general, consumer difficulty in identifying weak insurers, possibly weak incentives for solvency by some insurers, and high costs to consumers of insurance company failure provide the major rationales for government monitoring of solvency (including controls on insurer behavior) and government guarantees of insurer obligations in the event of insolvency.¹ The case for government monitoring will be presented first, assuming that government guarantees of insurer obligations do not exist. The case for government guarantees and their relation to monitoring will then be discussed.

Government monitoring. The expected cost to insurers of providing coverage declines as insolvency risk grows. The costs of evaluating insurer insolvency risk are high for many consumers. If some consumers cannot identify financially weak insurers at the time coverage is purchased and some firms have weak incentives for solvency, uninformed consumers will be attracted to insurers with low prices but high insolvency risk. If all consumers are uninformed, financially weak insurers might drive out all safe firms by charging lower prices. Since consumers would soon learn that their insurance had little value, demand for coverage would decline. Moreover, even if consumers could costlessly and accurately evaluate solvency risk prior to purchase, they would remain vulnerable to changes in insurer behavior that would increase insolvency risk and appropriate policyholder wealth after the time of sale.²

¹ For further discussion of several of these issues see Munch and Smallwood (1981), Finsinger and Pauly (1984), and Kunreuther, Kleindorfer, and Pauly (1983).

² Such changes in behavior could be especially likely if an insurer's financial condition were seriously weakened by adverse experience.

In principle, government regulation can prevent or at least mitigate these problems. Insurers with the incentive to be safe would be likely to demand such regulation. In addition, a high incidence of insolvencies without solvency regulation would be likely to stimulate substantial consumer awareness of insolvency risk and motivate some insurers to undertake a variety of activities to bond future claim payments, such as restrictions on minimum capital and payments of funds to policy owners. One likely type of restrictive covenant would be an agreement for the insurer to submit to external monitoring. A rationale for government monitoring is that it could be less costly than multiple private arrangements.

Compulsory insurance requirements provide another motive for government monitoring of insurer insolvency risk. For example, persons with few assets to protect are likely to demand low-premium, low-quality compulsory liability coverage. Since the market could be expected to meet this demand, government regulation of solvency might be needed to achieve the underlying policy objective of compulsory coverage.

Government guarantees. Since safety is costly, the efficient level of insurer insolvency risk will not be zero. Absent government guarantees of insurer obligations, insolvency would impose large costs on policyholders, and they are likely to demand some protection against such costs. Risk-averse policyholders will be willing to pay more than the expected cost of unpaid claims to receive such protection. Private provision of such protection may be infeasible, given the possibly high correlation across insurers in factors causing insolvency and the large amounts of capital needed to insure the solvency of a private guarantor. However, it is possible that public provision of mandatory coverage with the costs spread broadly among insurance buyers could be efficient.

The possibility that failure of one insurer or rumors of trouble could produce a "run" that would adversely affect otherwise solvent insurers might provide a second motive for government guarantees. Without government guarantees, it is possible that a run could occur if a failure led to cash flow problems and ultimate liquidation of assets (tangible or intangible) at prices below their true value. However, this motive would appear to be much weaker for property-liability insurers than in a fractional reserve banking system.

Unless all policyholders are unable to identify safe insurers, a major drawback of government guarantees is that they are likely to increase the incidence of insolvency. The reason for this is that accurate risk-based premiums are likely to be infeasible in practice. Hence, government guarantees will involve moral hazard: policyholders will have less incentive to buy coverage from safe insurers and some insurers will have less incentive to be safe.

Since government guarantees erode market discipline for high-risk

insurers, regulation must provide more discipline if an increase in the frequency and severity of insolvencies is to be avoided. However, increases in regulatory monitoring are unlikely to offset completely the effects of reduced private incentives, for two reasons. First, the amount of information and knowledge concerning insurer safety that is available to regulators will not equal that diffused among and communicated through large numbers of market participants and transactions. Second, if government guarantees spread the cost of insurer insolvencies broadly among insurers, policyholders, and taxpayers, they can reduce pressure on government to commit resources and adopt internal controls that are necessary for efficient monitoring. The extent to which this occurs depends on the design of guarantees. Among other factors, if insolvencies impose costs on the owners of safe insurers, they will have greater incentive to demand regulatory actions to control these costs. I return to this subject below.

The general literature on moral hazard in insurance (for example, Shavell 1979) suggests that it is likely to make partial insurance coverage optimal. This implies that efficient guaranty fund protection will not provide complete protection to policyholders and, intuitively, that the optimal "co-payment" will be relatively greater for consumers who are best able to monitor insolvency risk—that is, consumers who can monitor at relatively low cost. A complicating factor is that co-payments will not induce greater monitoring if the costs are borne by other parties, as would be true if the liability insurer of a judgment-proof tortfeasor were to become insolvent.

Solvency Regulation in Practice

State governments have primary responsibility for insurance regulation. Some coordination and uniformity among the states is achieved through the National Association of Insurance Commissioners (NAIC), which promulgates insurer financial reporting requirements and adopts model legislative bills for consideration by individual states. Primary responsibility for solvency regulation of an insurer traditionally has rested with regulators in its state of domicile.

Overview of state solvency regulation. Solvency regulation has three main facets: (1) controls over insurer operations, such as licensing requirements, minimum net worth requirements, and limitations on choice of investments; (2) monitoring of insurer financial condition, including periodic on-site examinations; and (3) a system for paying a portion of the claims of insolvent insurers. The most important monitoring system is administered by the NAIC. A team of examiners uses statistical analysis of financial ratios and scrutiny of financial results to prioritize insurers for further regulatory review or action by regulators in the state of domicile.

Most states enacted guaranty funds after the NAIC adopted a model property-liability insurer guaranty fund bill in 1969.³ With the exception of New York, which has a pre-funded plan, each state's guaranty fund assesses surviving insurers (in proportion to their premium volume in the state) for amounts needed to pay covered claims of its citizens (Figure 1). Most states limit coverage to \$300,000 or less per claim except for workers' compensation insurance claims, which usually are fully covered. The maximum assessment on insurers in any one year generally is limited to either 1 or 2 percent of state premium volume. If the limit is reached, additional assessments are made in subsequent years.⁴

Causes of recent insolvencies. During the period 1984-89, the number of property-liability insurer insolvencies was much larger than historical norms, but the annual insolvency rate was always less than 1 percent of all insurers. Net assessments by guaranty funds increased dramatically during this period (Figure 1) but they still represented less than one-half of 1 percent of nationwide premiums in each year.⁵ Many insurers that failed in the 1980s wrote relatively greater amounts of commercial insurance, compared to earlier periods when insolvent insurers more often had specialized in auto coverage.

The increase in property-liability insurer insolvencies has led to substantial controversy over the underlying causes and the efficacy of state solvency regulation. Much of this controversy revolves around a report issued by a U.S. House of Representatives subcommittee chaired by Rep. John Dingell (D., Mich.), following an 18-month investigation. The Dingell report blames insolvencies on insurer fraud and mismanagement coupled with ineffectual regulation and raises the specter of another savings and loan type disaster unless something is done.⁶

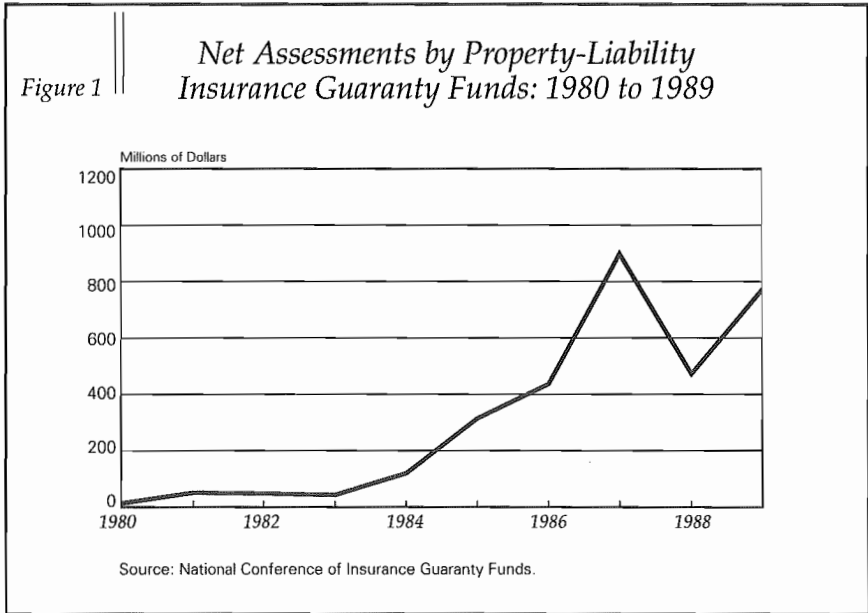
The Dingell report reiterates many criticisms of state solvency regulation that have been discussed for the past 20 years. Specific criticisms include insufficient resources devoted to regulation, use of unreliable information, lack of coordination among regulators in different states, infrequent and poorly prioritized on-site financial examinations, and the absence in many states of requirements for independent

³ This followed the introduction of a bill in the U.S. Senate that would have created a federal guaranty system. At that time only a few states had guaranty systems.

⁴ Guaranty fund laws in a majority of states include a provision that permits insurers to raise subsequent premiums to cover the costs of assessments. However, in a competitive environment, premium rates will only reflect the expected cost of assessments from new and renewal sales rather than the cost of assessments related to coverage sold in prior years. Other states require premium surcharges for assessments or allow insurers to offset assessments against state premium taxes over a period of years.

⁵ Premiums written for the industry totaled \$208 billion in 1989.

⁶ For further discussion and critique of this report, see Harrington (1991). Also see NAIC (1990).



CPA audits of insurer financial statements, for certification of loss reserves by an actuary, or both.

The report focuses on four property-liability insurer insolvencies, three of which (Mission Insurance Company and affiliates, Integrity Insurance Company, and Transit Casualty Insurance Company) are large compared to historical norms. As of year-end 1989, net guaranty fund assessments for these three insolvencies totaled almost \$900 million. The National Conference of Insurance Guaranty Funds (NCIGF) projected that net assessments ultimately would total \$1.3 billion, but the magnitude of the ultimate deficit and required guaranty fund assessments is subject to significant uncertainty.⁷

The Dingell report and other anecdotal analyses generally suggest, based on hindsight, that these insurers undertook rapid growth in new and risky product lines and charged substantially inadequate prices and established woefully deficient loss reserves (reported liabilities for claim costs). Inadequate prices and loss reserves are frequently emphasized in postmortems of insurers. However, as is discussed further below, it is

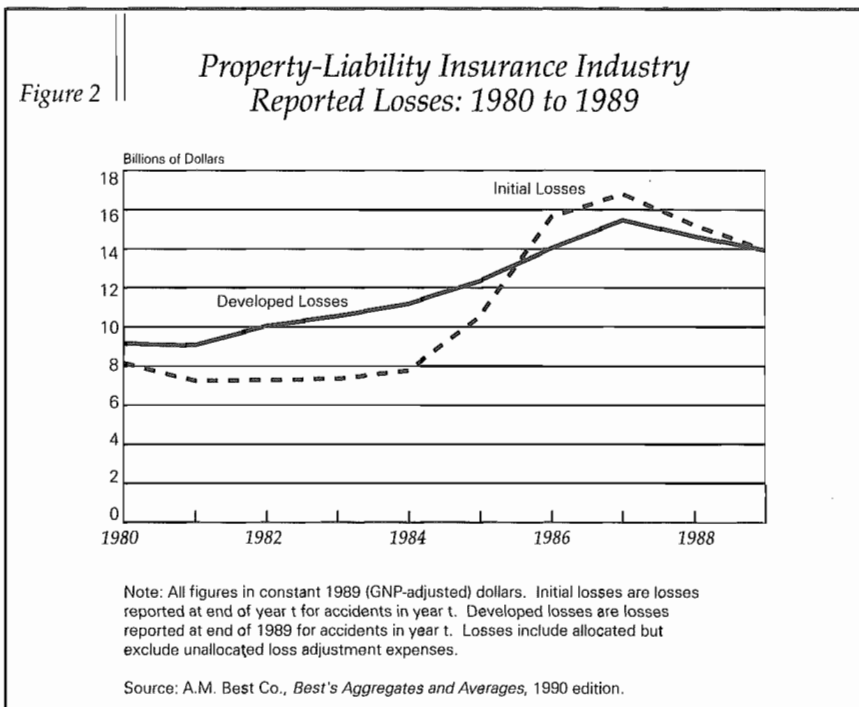
⁷ According to the Dingell report, the receivers for these insolvencies estimated a total deficit of \$5 billion. Transit Casualty accounted for over one-half of this amount, but the report suggested that the estimate for Transit Casualty could contain substantial error. As of year-end 1989, the NCIGF projected net assessments of approximately \$300 million for this company.

usually difficult to determine the extent to which these phenomena reflect unfavorable realizations in losses as opposed to deliberate underpricing and under-reserving. Mission, Integrity, and Transit Casualty also made extensive use of managing general agents authorized to make risk selection and pricing decisions and to arrange for reinsurance. Much of the insurance and reinsurance sold by these insurers was reinsured with hundreds of different U.S. and foreign reinsurers. Some of these reinsurers became insolvent and did not pay amounts owed Mission, Integrity, and Transit Casualty. Many others are denying payment, alleging fraudulent concealment of information by these companies. These disputes are now being litigated.

As has been the case for some synopses of the savings and loan mess, allegations that property-liability insurer insolvencies are due mainly to incompetence and moral turpitude are exaggerated and incomplete. At least two other causes need to be considered. First, unexpected growth in liability claim costs for policies sold during the early 1980s undoubtedly contributed to the increase in the number and magnitude of property-liability insurer insolvencies, which began in 1984 (Figure 2).⁸ This increase in insolvencies followed sharply deteriorating industry financial results for commercial liability insurance coverage and coincided with the onset of the highly publicized liability insurance crisis.

Mission, Integrity, and Transit Casualty had been in business for many years prior to insolvency, had received the highest financial rating from the major insurance company rating agency (the A.M. Best Company) almost until the time that regulatory action was taken, and had been audited by leading CPA firms. As the Dingell report emphasizes, these insurers rapidly expanded sales of liability coverage prior to insolvency. In retrospect, much of this coverage was very risky; for example, toxic waste liability, products liability for pharmaceutical companies, excess limits coverage, and reinsurance. Based on hindsight, the Dingell report concludes that these companies engaged in massive and deliberate understatement of loss reserves. However, a significant amount of the reserve inadequacy for these and other insurers that failed since 1984 is likely to have been caused by unpredictable increases in both the frequency and severity of claims, even if financial problems associated with such increases did cause some in-

⁸ General liability insurance includes coverage for products liability, environmental liability, and the like. While some of the growth illustrated in Figure 2 could reflect deliberate understatement of loss reserves in the early 1980s, the data nonetheless suggest substantial unexpected growth in claim costs. The data do not include the experience of insurers that later became insolvent. Such companies may have been most likely to deliberately understate loss reserves in the early 1980s.



surers to pursue high-risk strategies in the face of imminent insolvency—that is, to “go for broke” or “gamble for resurrection.”

Second, although little is known about this issue, interest rate risk also might have played a significant role in the problems of some insurers, as was the case for many savings and loans. Property-liability insurers invest mainly in medium- and long-term government and high-grade corporate bonds. Since changes in interest rates generally have a greater impact on the value of these investments than on the value of insurer liabilities, the market value of property-liability insurer net worth is negatively related to interest rates. It is possible that increases in interest rates in the early 1980s, in conjunction with unexpected increases in claim costs, produced severe financial problems or actual insolvency for some insurers. These problems may have led some of these insurers to go for broke.

The property-liability insurance market also appears to be characterized by cyclical fluctuations in prices. While the causes of such fluctuations are not fully understood, cyclical reductions in commercial liability insurance prices during the early 1980s could have contributed to the financial problems and subsequent insolvency of some insurers (Harrington and Danzon 1991).

The role of guaranty funds. It would be very difficult or impossible to sort out the effects of guaranty funds from other factors that cause insolvency. Based on theory, it is highly probable that guaranty funds contributed to the increased frequency and severity of insolvencies in recent years, as well as to the greater prevalence of insolvent insurers that wrote significant amounts of commercial insurance as opposed to personal auto coverage. As noted earlier, guaranty fund protection can encourage entry and growth of weak insurers with low premiums, and it can facilitate go for broke behavior by insurers that have been wounded by exogenous influences.⁹

Without guaranty fund protection, many insurance buyers would have much less incentive to choose an insurer with the lowest premium, regardless of its safety. Although many insurance buyers might be ill-prepared to assess insurer financial strength, others (such as large commercial buyers, or agents and brokers) are better able to do so. Moreover, a strong preference for safety would motivate insurers to make their promises to pay claims more credible to all buyers. This could be achieved by holding more capital, by obtaining high ratings from private financial rating services, and the like. Agents and brokers would be more motivated to identify and deal with safe insurers in order to avoid loss of future income due to policyholder departures in the event that an insurer failed. Other parties, such as providers of mortgages and auto loans, also would be expected to pay more attention to insurer safety.

Contrary to complaints that guaranty fund protection may be inadequate, a significant advantage of property-liability insurance guaranty funds is that coverage is limited.¹⁰ Expansion in the scope of guaranty fund protection should be avoided. Instead, the scope of protection probably can be reduced to achieve a better balance between providing incentives for safety and protecting consumers from losses in the event of insolvency. One approach is to reduce or even eliminate guaranty fund protection for commercial insurance. This would increase incentives for commercial buyers to deal with safe insurers and discourage them from buying coverage that they know is underpriced. Variants of this approach have been endorsed by a large insurer trade group and by the NAIC, and about 10 states have adopted limitations related to net worth of commercial insurance buyers. A majority of state guaranty

⁹ Insurers with substantial intangible assets (such as those that arise from investments in sales forces) that could be lost in the event of insolvency have considerable incentive to operate safely regardless of the scope of guaranty fund protection. However, guaranty fund protection gives buyers less incentive to purchase coverage from such insurers unless their intangible assets are associated with the provision of desired services.

¹⁰ Life-health guaranty fund coverage is even less comprehensive and is arguably inadequate in some states.

funds contain small deductibles for covered claims. Consideration also might be given to incorporating a coinsurance provision that would require buyers (commercial only or both commercial and personal) with guaranty fund protection to bear a percentage (for example, 10 percent) of their loss above any deductible in the event of insolvency, unless the loss falls on some party other than the buyer.

Changes of this type can be made only if political pressure for expansion of guaranty fund protection is overcome. The benefits of guaranty fund protection are obvious and highly visible to the public; the costs are spread broadly and are largely invisible. The popular media seem to emphasize incomplete coverage under existing guaranty funds rather than promote informed discussion of the advantages of further restrictions.

The adoption of risk-based capital requirements for insurers or advance, risk-based premiums for insurance guaranty funds also might mitigate the adverse effects of guaranty fund protection on incentives for safety. An NAIC task force is studying the former possibility. These proposals have theoretical appeal, but their successful application is likely to be hindered by inability to measure insurer risk accurately, especially the magnitude of insurer liabilities. Moreover, regulatory choice of capital standards or risk-based premium rates also would be subject to substantial political pressure.

Any state guaranty fund system with advance premiums (as opposed to current post-insolvency assessment schemes) also would create a risk that accumulated funds would be appropriated by state legislatures for non-insurance purposes.¹¹ Perhaps more important, post-insolvency assessment in many states may provide financially strong insurers (and their trade organizations) with more incentive to exert pressure for effective solvency surveillance and efficient liquidation of insolvent insurers than would be the case with advance premiums. The reason for this is that unexpected increases in the costs of assessments are likely to be borne by owners, as opposed to being fully shifted to customers or taxpayers.¹²

Is Federal Regulation Desirable?

The increase in property-liability insurer insolvencies has led to valid concern about the ability of regulation to detect and deal with aggressive pricing and deliberate understatement of loss reserves, as

¹¹ Experience under New York's advance premium system provides some support for this concern.

¹² The desire to avoid loss of premium tax revenue in states that allow offset of guaranty fund assessments against premium taxes also might produce pressure for controlling the cost of assessments.

well as with the extent to which reinsurance can be used to finance excessive growth. However, based on evaluation of industry net worth relative to liabilities and, perhaps, recent actions by the NAIC (described later in this section), industry analysts generally believe that the financial condition of the property-liability insurance industry is basically sound (Stevenson 1990; McCauley and Siemek 1990). Under the current regulatory system and reasonable economic scenarios, it is implausible that insolvency problems in insurance will even begin to rival those of the savings and loan industry.

Nonetheless, it is highly probable that legislation will soon be introduced that will provide for some federal role in insurance regulation. While few details are available, it is possible that such legislation will require minimum federal standards for state solvency regulation and provide for direct federal regulation of reinsurers and surplus lines insurers.¹³ Other frequently discussed proposals for federal intervention in solvency regulation, some of which have a long history, include an option for federal regulation of companies that operate in many states, and a federal insurance guaranty program.

The NAIC has taken a number of steps during the past several years designed to improve solvency regulation (NAIC 1990). The extent to which pressure generated by the Dingell investigation influenced some of these changes is not clear. It is likely to have had some effect. Model bills have been enacted or amended to require increased disclosure and oversight of the activities of managing general agents and reinsurance brokers and managers, and to significantly strengthen conditions that reinsurers must meet before insurers can reduce their reported liabilities to reflect reinsurance purchases. The amount of financial statement disclosure for reinsurance transactions and loss reserves was significantly expanded. The NAIC also adopted minimum standards for state solvency regulation and a mechanism for certifying state compliance.

The establishment of minimum standards by the NAIC weakens the case for federal standards. At least 15 states have requested certification; many others are considering legislation needed to achieve compliance. If some states fail to take action, their insurers will be likely to receive greater scrutiny in other states where they do business (or in states where they may be seeking a license). The attendant erosion in traditional deference to domiciliary regulators will create pressure for certification. Financially strong insurers also can be expected to pressure for certification of their home states.

Recent insolvency experience and debate should lead to improved monitoring by state regulators. It is clear that regulators need to pay

¹³ Surplus lines insurers sell coverage in a state without being licensed and subject to full regulation.

close attention to insurers with rapid growth and extensive use of reinsurance in product lines that are difficult to price. This is especially important if most of their policyholders are largely protected by guaranty funds, if their owners or principals have little to lose from insolvency, or both. More attention also should be devoted to measuring interest rate risk and to estimating and monitoring the market value of net worth.

In principle, increased centralization of solvency regulation has its advantages (for example, reduction in possibly inefficient duplication of effort, better coordination of liquidations of multistate insurers, and so on). However, it is not clear that politically induced inefficiencies would be smaller with federal regulation. In fact, they could be greater. Given the history of federal guarantees for depository institutions, the risk that federal intervention in insurance solvency regulation will ultimately lead to an inefficient expansion in the scope of guaranty fund protection is not trivial. Spreading the cost of insolvencies even more broadly through a federal guaranty system, which probably would be "pre-funded" (and most assuredly would be backed by taxpayers), is the one thing that should be avoided if the objective of policy is to minimize the total cost of insurer insolvencies.

Moreover, while one might hope that the Congress would learn from past mistakes, congressional inaction in dealing with mounting insolvency costs for savings and loans is relevant to the debate over insurance regulation. The deliberate congressional policy of "forbearance" for insolvent thrifts, which multiplied the total cost of insolvency by allowing go for broke behavior, is (or at least should be) sobering in this regard. It has been argued persuasively that the policy of forbearance was not an aberration; it was an ordinary and routine response to constituent pressure (Romer and Weingast 1990). State regulators also may face considerable pressure to delay liquidation of insolvent domestic insurers, but regulators in other states will face less pressure to do nothing while losses mount, and deference to domiciliary regulators is not without limits. Moreover, any shortcomings of state regulation that allowed the costs of recent property-liability insurer insolvencies to increase seem trivial compared to the federal policy of deliberate forbearance for insolvent savings and loans. Since the incentives facing the Congress have not obviously changed, it is not at all clear that a fiasco of this sort cannot happen in some other area.

Rate Regulation

Government regulation can affect the average overall rate level for an insurer. For a given average rate level, it also can affect the level of rates paid by consumers with different characteristics (for example, by

restricting rate classification). If regulation suppresses rates below market levels, whether overall or selectively, supply shortages can be prevented, at least in the short run, by mandating service to all customers through involuntary market mechanisms such as reinsurance pools, joint underwriting associations, and assigned risk plans.

Rationales for Rate Regulation

Little or no justification exists for regulation of property-liability insurance rates to enhance efficiency. The competitive structure of most property-liability insurance markets, most notably the absence of substantive entry barriers, is inconsistent with supra-cost pricing in long-run equilibrium. The industry's limited antitrust exemption does not alter this conclusion, as will be discussed below. Entry barriers for the sale and underwriting of insurance by other institutions, such as banks, might possibly prevent the introduction of alternative technologies, but they will not produce supra-cost prices. Hence, regulatory limits on maximum rate levels are not justified (Joskow 1973; Klein 1989; and Cummins and Tennyson 1991; also see Harrington 1990).

The use of regulation to establish minimum rates has been suggested as a means to reduce insolvency risk for some insurers and perhaps to dampen any cyclical fluctuations in prices.¹⁴ Even if this approach were politically feasible, it is not at all clear that it would be preferable to regulatory monitoring of pricing and risk-taking, especially in view of the anti-competitive potential of minimum rate regulation.

Adverse selection with asymmetric information could provide some rationale for government establishment of residual markets and regulation of residual market rates but evidence suggests that these markets are very small, absent substantive regulatory suppression of voluntary or residual market prices. Theoretical work on insurance pricing also raises the possibility that insurers may engage in some inefficient risk classification (Crocker and Snow 1986), but again this is not likely to justify significant intervention in insurer pricing and risk selection decisions. Finally, theory suggests the possibility of efficiency gains from subsidizing liability insurance rates for some persons or entities that might otherwise engage in risky activity without liability coverage (Keeton and Kwerel 1984). Even if this is true in principle, regulators do not have the knowledge of individual consumer preferences that is necessary for efficient implementation (that is, for target efficiency).

¹⁴ Several states passed "flex-rating" laws following the liability insurance crisis of the mid 1980s. The alleged purpose of these laws, which require approval of percentage rate changes in excess of specified benchmarks, was to reduce price-cutting in so-called "soft" markets that was believed to affect subsequent price increases and availability problems in "hard" markets.

Rate Regulation in Practice

Rate regulation across states is very diverse, both in terms of statutory authority for rate regulation and implementation by state insurance commissions. In personal auto insurance, for example, over 20 states have "competitive rating laws" intended to allow market competition to determine rates. The remaining states require some form of prior approval by regulators before rates are changed. Rate regulation in some of these states is probably pro forma. In contrast, for many years a relatively small number of states, including Massachusetts, New Jersey, and South Carolina, have employed comprehensive rate regulation with varying degrees of overall rate suppression and restrictions on rate classification. The results of such policies have included large involuntary markets and exits by many insurers.¹⁵

The trend in both auto insurance and workers' compensation insurance in the past several years has been toward greater regulatory intervention to limit price increases. While workers' compensation was exempted, this trend is exemplified by the passage of Proposition 103 in California, with its populist proposal for an across-the-board rate rollback for most property-liability lines, its limits on rate classification, and its institution of prior approval rate regulation. The greater politicization of rate regulation in auto and workers' compensation insurance coincides with increases in the underlying costs of providing coverage and thus in premium rates that would be charged in the absence of regulation.

Attempts to make coverage more affordable through rate regulation cannot be reconciled with economic efficiency. Proponents of public-utility-style rate of return regulation (including limits on allowable operating expenses) and restrictions on rate classification argue that insurance rates are too high because of inadequate competition that produces inefficiency and excessive profits (Consumer Federation of America et al. 1989). They also argue that rate classification is arbitrary and unfair (or that insurers somehow fail to do it correctly). While they argue for repeal of the industry's antitrust exemption in order to promote competition, their regulatory agenda is completely at odds with this goal. These claims cannot be reconciled with the industry's competitive structure, especially ease of entry. Again, the antitrust exemption does not alter this conclusion. If it did, the efficient solution would be to modify the exemption, not to expand rate regulation.

While measurement of insurer profits and rates of return is prob-

¹⁵ For example, 15 insurer groups left the South Carolina automobile insurance market in 1990, mainly because of the adverse regulatory environment.

lematic, accounting data do not suggest excessive returns.¹⁶ Claims of widespread inefficiency usually point to "large" ratios of operating expenses to premiums. The costs of settling and paying claims (for example, attorneys' fees) are lumped together with commissions to agents, risk selection and policy issue costs, and state premium taxes. The level of claim costs is usually not mentioned, unless it is to castigate insurers for not doing enough to reduce accident rates.

The argument that insurance markets exhibit widespread inefficiency implies that insurers are willing to leave large amounts of money on the table. Instead, insurers have substantial incentive (the lure of higher profits) to minimize costs, including both the sum of claim payments and claim settlement expenses and the cost of product distribution necessary to provide a given level of service. The argument that the insurance industry is highly inefficient also presumes an absence of competition. If a large part of the market could be served at lower cost, why does some company not do so, given the immense profit potential? Why do consumers upset by high premiums not flock to insurers with lower expenses, if by doing so they could pay less without any reduction in service? If rate regulation somehow distorts incentives for efficiency, the efficient policy is to abandon rate regulation, not to control expenses.

It is possible that some inefficient insurers could survive if consumers find it difficult to identify low-cost insurers. Whether this is an important problem in insurance markets has been disputed by academic researchers (for example, Dahlby and West 1986). My own view is that it is implausible that significantly greater premiums for large numbers of buyers could be due to costly consumer search. Moreover, to the extent that comparison shopping is difficult enough to justify action by the government, the preferred mode of regulation is increased information disclosure rather than rate regulation or restrictions on insurer expense levels.

Consequences of rate suppression. The use of rate regulation to suppress rates has several adverse consequences that are suggested by basic economic theory and, in some instances, empirical evidence (see, for example, Grabowski, Viscusi, and Evans 1989; Rottenberg 1989). Rate suppression will make less coverage available voluntarily. This produces larger involuntary markets, such as joint underwriting associations and

¹⁶ Available evidence on profitability in the property-liability insurance industry, although subject to considerable debate, does not indicate excessive profits or rates of return on net worth. While details differ, most analyses suggest that the rate of return on net worth for the overall industry during recent years has averaged around 10 percent. (See, for example, Insurance Services Office 1989; also see Cummins and Tennyson 1991.) Measurement of insurer profitability is problematic for several reasons. See Harrington (1988) for details.

reinsurance pools. It also provides an incentive for insurers to reduce product quality, perhaps in some cases by increasing insolvency risk. As noted, continued restrictions on rates also have influenced exit by some insurers.

Rate suppression and the mandated markets that tend to follow also are likely to produce significant cross-subsidies. Rates tend to increase for consumers who, on average, have low expected claim costs so that high-risk buyers can pay below-market rates. Such policies reduce the incentive for high-risk buyers to control claim costs. Moreover, by requiring insurers to pool claim costs among companies, reinsurance facilities and joint underwriting associations are likely to reduce the incentive for individual insurers to settle claims efficiently. It is also possible that rate suppression reduces political pressure on state legislatures to adopt potentially desirable forms of claim cost control.

Restrictive rate regulation also can produce long and costly rate hearings, in which insurance industry employees, state government employees, consultants, advocates, other experts, and counsel for all parties engage in unresolvable arguments concerning issues such as the magnitude of future loss costs, the appropriate size of premium loadings for insurer expenses and income taxes, and the rate of return needed by insurers.

The application of public-utility-style rate of return regulation in the property-liability insurance market is subject to particularly severe shortcomings. The rate base chosen, which is likely to be accounting net worth, may diverge significantly from economic net worth for many companies, especially those with substantial intangible assets that reflect the value of investments in distribution systems, product development, claims facilities, and human capital. The amount of net worth necessary to write a given level of insurance also must be specified. Any fixed norm will be likely to distort supply in a number of ways. Low norms will produce lower premiums but will give insurers incentive either to exit or to reduce net worth and thus increase insolvency risk. It also is necessary to allocate an insurer's net worth by line and by state for insurers that write multiple lines in multiple states. This allocation has no compelling theoretical basis and the use of norms fixed by line and by state is likely to cause undesirable fluctuations in the supply of coverage. For example, a norm that allocates less (more) net worth than an insurer feels is necessary to write a given level of coverage will cause the insurer to contract (expand) supply or perhaps reduce (increase) quality for that line of business.

Rate of return regulation for utilities commonly is based largely on historical costs of providing services, along with specified procedures for allowing for future increases in labor and fuel costs. Insurance rate-making is not amenable to these simple procedures. The magnitude of insurance claim costs generally is much less certain than utility costs,

and the magnitude of costs becomes known much more slowly than for utilities, especially for long-tailed liability lines. Moreover, considerable heterogeneity in expected claim costs often exists among insurers that write business in a given line or state. Attempts to use fixed formulas and procedures to forecast losses under rate regulation again would be likely to lead to serious distortions in supply, and they would have an unequal effect across companies. Attempts by regulators to conduct detailed analyses of the anticipated loss experience for each company and line of business would lead to costly duplication of insurer activities. They also would be likely to produce unresolvable disputes about various factors that could affect future costs.

Price regulation also tends to reduce the incentive for companies to adopt efficient innovations over time. If, for example, an insurer were limited to a specified rate of return on net worth, the potential for increased profits from the development of new procedures that reduced operating expenses would largely disappear. As a result, the insurer would be less likely to fund a given investment, and expenditures for research on cost-saving or service-enhancing innovations would be expected to decline.

All of these problems with rate of return regulation might be necessary evils for natural monopolies. Rate of return regulation for property-liability insurers can only be justified if the policy objective is to have prices determined by political pressure rather than competition.

The Antitrust Exemption

The McCarran-Ferguson Act, which was enacted by the Congress in 1945, endorses the primacy of state regulation of insurance and provides the industry with an exemption from federal antitrust law for activities that are subject to state oversight and that do not involve boycott, coercion, and intimidation. A number of cooperative activities have developed under this exemption, most importantly the development of policy forms and estimation and dissemination of "prospective loss costs" by industry advisory organizations. Advisory organizations have also promulgated "advisory rates" that included expense and profit loadings, but this is being phased out.¹⁷ Some form of cooperative development of policy forms and sharing of data on paid claims would be likely to survive antitrust scrutiny. Advisory organization estimation of ultimate costs for claims already incurred (known as loss develop-

¹⁷ The original version of this paper stated that advisory rates had already been discontinued. In his comments on the paper, J. Robert Hunter pointed out that this was not the case.

ment) probably would survive; forecasting of costs for future claims (known as trending) almost certainly would not. Legislation has been introduced in the U.S. House by Rep. Jack Brooks (D., Texas) that would virtually repeal the insurance industry's antitrust exemption.¹⁸

Rationale for the Antitrust Exemption

The cost of insurance rate-making for any of the hundreds of lines and sublines of coverage is largely fixed. Loss forecasting involves the estimation of ultimate claim costs on claims already incurred, using data on paid claims, and prediction of claim costs for new and renewal coverage using this and other information. Advisory organizations pool information from a large number of insurers and forecast losses, and make the results available to companies at cost for use as they see fit. It is argued that this process lowers the cost of rate-making, reduces entry barriers, and increases forecast accuracy (and thus lowers insolvency risk), especially for small insurers with few data of their own. Cooperative development of policy forms also reduces fixed costs, facilitates comparisons of price and quality of service by consumers, and helps make claim cost data comparable across companies.

Centralized production of information by advisory organizations obviously is much less costly than if the same activities were duplicated by many firms. Whether the development of prospective loss costs by advisory organizations yields significant efficiency gains depends on their value in improving individual insurer forecasts. This in turn depends on many factors, including the extent to which firms can infer information of other firms from their behavior or from prices. If the information provided by advisory organizations has significant value, its availability at low cost is likely to increase its use and to reduce forecast error variance and thus capital requirements. The result would be lower prices for any given level of insolvency risk. Of course, this result assumes that the cooperative activity does not produce active or tacit collusion.

The Antitrust Exemption in Practice

Dramatic growth in commercial liability insurance premiums between 1984 and 1986 produced allegations that insurers were colluding to raise rates above costs and calls for the Congress to modify or repeal the McCarran-Ferguson Act (Angoff 1988). A 1988 federal antitrust suit

¹⁸ The bill includes safe harbors for sharing of data on paid claims and estimation of costs for claims already incurred. It would not protect estimation of future costs following a transition period. No safe harbor is provided for development of policy forms.

by the attorneys general of many states, alleging collusion in conjunction with changes in the principal general liability insurance coverage form, was subsequently dismissed but generated substantial negative publicity for the antitrust exemption.¹⁹

A large amount of research dealing with causes of the mid 1980s liability insurance crisis concludes that collusion is an implausible explanation and suggests a variety of economic factors that led to these problems (Clarke et al. 1988; Harrington 1988; Harrington and Litan 1988; Winter 1988; Priest 1987; and Cummins and Danzon 1990). In general, the industry is ill-suited for cartel behavior given its competitive structure, heterogeneity, and multiplicity of product lines. There is no evidence that modern advisory organizations attempt to compel the use of prospective loss costs (or advisory rates). Moreover, commercial liability insurance pricing is characterized by substantial flexibility, including the widespread use of individual risk rating, which is *prima facie* inconsistent with price fixing. In auto insurance, most of the major insurers file their own rates as opposed to using advisory organization data (Danzon 1983; Eisenach 1985).

The outlook for changes in the McCarran-Ferguson Act is uncertain. Support for curtailment or elimination of the antitrust exemption has come from consumer groups and from persons with strong faith in the efficacy of antitrust law. It is likely that some supporters of federal insurance regulation favor change in the Act because it will erode the primacy of state regulation. Insurers and trade groups are divided on the subject. Some insurer trade groups apparently are willing to compromise and accept some change in the exemption. Other insurers are willing to repeal the exemption in exchange for an exemption from state rate regulation.

Substantial change in the McCarran-Ferguson Act's antitrust exemption almost certainly will not enhance the affordability and availability of coverage. At worst, it will produce higher prices and less stability. The only certainty is that a significant change (such as enactment of the Brooks bill) will produce a large amount of uncertainty about what is legal and the possibility of substantial litigation. The likely result is a significant transfer of resources to the legal profession.

¹⁹ A similar state antitrust suit in Texas was settled in 1991. Ayres and Seligman (1989) and Priest (1989) provide opposing economic views of the antitrust suit. Priest presents a compelling case that the anticompetitive story of Ayres and Seligman is without significant merit.

Conclusions

The case for federal regulation of insurance company solvency is not compelling. Federal intervention could set the stage for significant, inefficient expansion in government guarantees of insurer obligations. What would promote efficiency is the greater reliance on market discipline that would be induced by reducing guaranty fund protection for commercial insurance buyers. Holding the line on guaranty fund protection, and, if possible, reducing its scope, is probably the single most important step that can be taken to ensure the financial integrity of the insurance industry.

Additional government control over insurance rates is not needed. It would be likely to produce significant inefficiency, including higher claim costs. Instead, rates should be deregulated, and insurance affordability problems should be addressed by measures that reduce claim costs in efficient ways. Finally, changing the insurance industry's antitrust exemption will not reduce insolvencies, make insurance more affordable, or dampen volatility in prices and availability. It could make these problems much worse.

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Discussion

*J. Robert Hunter**

The positions expressed in Scott E. Harrington's paper represent an effort in what I would term forensic scholarship. His point of view is similar to the positions taken by his insurance industry clients. Consider, for instance, how Harrington strains to make points favorable to long-standing positions held by insurers:

- (1) He writes that "efficiency would be served by deregulation of rates," and at the same time suggests maintaining the antitrust exemption. What could be nicer for insurance companies than deregulated cartel pricing? What could be worse for America's insurance consumers?
- (2) He finds that solvency is adversely affected by insurance "uncertainty," totally ignoring the fact that studies of the riskiness of property-casualty insurance reveal average risk. Indeed, although insurers claim below-average returns over the last two decades, the property-casualty insurer stock index rose more than twice as fast as the Dow Jones Industrial Average.
- (3) He writes that "allegations that property-liability insurer insolvencies are due mainly to incompetence and moral turpitude are exaggerated and incomplete." Yet, elsewhere he notes that the Dingell report concluded that some insurers pursued "high-risk strategies," they were led "to 'go for broke'," that insurers engage in "deliberate understatement of reserves," and that some general liability insurers deliberately and massively understated loss reserves.

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- (4) Harrington writes, "Based on theory, it is highly probable that guaranty funds contributed to the increased frequency and severity of insolvencies in recent years," noting that "large commercial buyers" are better able to assess the financial strength of low-cost insurers. Why would a sophisticated buyer with millions at risk for liabilities to third parties want a \$300,000 cap from a guaranty fund? Not to mention all the wait and hassle to collect property claims from a guaranty fund?
- (5) Harrington finds a competitively structured market for property-liability insurance, but ignores the serious blocks to competition that a study of insurer conduct reveals: the antitrust exemption; the anti-rebate laws (a type of fair trade law, where the retail-level or agent price can be set and enforced by the wholesaler or insurer); and the anti-group laws (whereby people are not permitted to join together to buy insurance). He makes passing comment on the total barrier to bank entry, but not on the severe economic barrier to entry into direct writing of insurance, where the real competition for personal lines insurance occurs. He mentions, but fails to explore, the information barriers people face in trying to find the proper price/service information on insurers. He fails to mention the fear that consumers have of moving from insurer to insurer, because of the total freedom of underwriting and cancellation during the first 60 days of coverage with a new insurer, in most states.

In this discussion I hope to disabuse Harrington of the recommendations that I believe to be anti-consumer, namely, those that would:

- (1) Maintain the status quo as to state regulation of solvency, and decrease the coverage of the guaranty funds, particularly for commercial risks;
- (2) Deregulate rates; and
- (3) Maintain the antitrust exemption. (Harrington opines that freeing insurers from the cartel might produce even higher prices and less stability.)

Solvency/Guaranty Fund Issues

The real reason for the recent increase in insolvencies was the property-casualty insurance cycle, which bottomed in the mid 1980s and which I believe was itself caused by greed and/or incompetence of managers and incompetence of state regulators. Harrington lists the cycle only third among possible culprits. He believes that the first cause was reserve shortfall, and shows an exhibit (Harrington Figure 2) that indicates that in the early 1980s reserves were short by \$1 billion to \$4 billion, yet he does

not comment on the \$1 billion to \$2 billion reserve excess since 1985. This is simply classic cyclical behavior: keep reserves low when your profits fall, jack them up when they are great. Harrington's chart demonstrates that the cycle was a primary reason for the shortfall.

His second point, that bonds were down when interest rates were high, is interesting but also shows a misunderstanding of the property-liability business. Bonds are carried on the books at amortized value and are well matched with the "tail" of expected payouts. Thus, bond prices are, for most insurers, irrelevant to solvency.

The cycle was the culprit, driven by greed and mismanagement. As the head of American International Group (AIG) put it, if the insurers hadn't cut prices "to the point of absurdity," there wouldn't be "all this hullabaloo" about tort reform (Greenwald 1985).

State regulation has not worked well in the area of solvency. It has been too slow, and the problem with the guaranty associations is not that they cover too much, but too little.

As a 1991 study by the General Accounting Office found (p. 3):

Insurance regulators were typically late in taking formal action against financially troubled companies. . . . There are many possible reasons for regulatory delay. Among them are reliance on untimely or unverified information, lack of legal or regulatory standards for defining a troubled insurer, and a vague and unspecific statutory definition of insolvency.

I believe the case for federal minimum standards for solvency regulation is compelling. That the feds might set standards does not mean I favor a federal takeover of solvency regulation. I do not. I would hope that all states would meet the minimum standards and fully retain state regulation, except for areas that states may be unable to regulate, such as alien reinsurance and alien surplus lines markets. In these cases only, direct federal regulation may be necessary.

Relative to the guaranty associations, the coverage for personal lines and small ("ma and pa") commercial insurers should be expanded, not weakened. Harrington's call for elimination of commercial coverage should never extend to small business. Further, his lack of concern for the victims of corporate wrongdoing is alarming. Consider his suggestion of no coverage for commercial risks. Suppose the insurer of a product manufacturer fails. Assume further that the product is one like the Dalkon Shield, and that many women have been seriously injured by the product. I personally do not mind if large commercial enterprises such as A.H. Robins (the manufacturer of Dalkon) are liable in the event the insurer fails. But what if A.H. Robins also goes under? Should the women have no claim even then against the guaranty fund? Why further victimize them because both the insurer and the manufacturer failed?

Deregulation of Rates

If Harrington would agree to eliminate all of the anti-competitive forces at play in the property-casualty insurance markets (the antitrust exemption, the anti-rebate laws, the anti-group laws, the barriers to entry for banks, the information gap, the underwriting selection problem, at least for risks with good records, and the like), I could then agree that regulation of prices could be eased, even phased out. If the full forces of competition were at work, I would see no need for much rate regulation. But the quality of competition should be tested.

It is vital to repeal the McCarran-Ferguson Act's antitrust exemption, in order to start a process whereby states can choose to deregulate by eliminating their local anti-competitive rules, by establishing computerized price and service information, and so on. Alternatively, a state could choose to regulate, but the standard by which the courts would test the efficacy of regulation would be the state action doctrine rather than the non-standards of the McCarran-Ferguson Act.¹

If regulation is chosen, it should be real. As the National Association of Insurance Commissioners has found:

The (NAIC) Task Force concludes that total return ratemaking methodologies are the most appropriate . . . for states that choose to regulate rates.²

Years of state coddling under weak to useless regulations, coupled with no antitrust enforcement, have produced what we would expect, an amazingly inefficient, fat industry. Andrew Tobias, a financial author, put it this way (1982, pp. 24-25):

Roots of the industry's inefficiency are manifold. The fire insurance business grew up as a massive exercise in price-fixing. . . . One might expect the marketplace to impose its own economic discipline—it is competition based on price that has always been the surest spur to efficiency—but insurance prices . . . are notoriously hard to evaluate, leaving consumers unable to spot the best values and insurers under little pressure to provide them. Federal regulation and antitrust statutes largely exempt the insurance industry; state regulators are anxious to keep even inefficient companies profitable. . . .

If the market were truly competitive, good service would be expected to cost more, not less. Yet, when *Consumer Reports* listed the

¹ Under the McCarran-Ferguson Act, any law purporting to regulate insurance—even if unenforced—is sufficient to oust antitrust scrutiny. Under state action, the quality of regulation can be challenged by an abused consumer.

² The full NAIC adopted this report on June 6, 1984.

best service insurers for auto insurance,³ the top five and their 1989 expense ratios were:

Company	1989 Expense Ratio (Percent)
Amica Mutual Insurance Co. (Best Ranking)	36.5
United Services Auto Assn.	26.0
USAA Casualty	32.0
Auto-Owners Insurance Co.	36.7
Cincinnati Insurance Co.	42.9
Average	34.6

And the bottom five and their 1989 expense ratios were:

Company	1989 Expense Ratio (Percent)
Hanover Insurance Company (Worst Ranking)	47.3
General Accident Insurance Company of America	36.5
Metropolitan Property & Liability	39.0
Liberty Mutual Insurance Company	26.9
Travelers Indemnity	45.4
Average	39.0

Here are the top five homeowners insurance writers in service according to *Consumer Reports*,⁴ and their 1989 expense ratios:

Company	1989 Expense Ratio (Percent)
Amica Mutual Insurance (Best Ranking)	31.7
United Services Auto Association	34.0
Erie Insurance Exchange	28.5
State Farm Fire and Casualty	41.3
California State Auto Association	27.9
Average	32.7

³ *Consumer Reports*, October 1988 edition. The 1989 expense ratio is for private passenger auto liability insurance, taken from *Aggregates and Averages*, A.M. Best & Co., 1990 edition. The ratio includes loss adjustment expense.

⁴ *Consumer Reports*, September 1989 edition. The 1989 expense ratio is for homeowners' insurance, taken from *Aggregates and Averages*, A.M. Best & Co., 1990 edition. The ratio includes loss adjustment expense.

And the bottom five and their 1989 expense ratios:

Company	1989 Expense Ratio (Percent)
Metropolitan Property & Liability (Worst Ranking)	39.4
Prudential Property & Casualty	42.0
Travelers Indemnity	47.8
Allstate Insurance	37.4
Fireman's Fund Insurance	61.9
Average	45.7

Based on reviewing this sort of information for many years, looking at complaint ratio information from many states, and 30 years of study of the markets for insurance, I find no evidence that enough people know which are the low-cost, good-service insurers to justify the heroic conclusion that competition can regulate price in insurance. In fact, since the lower-cost insurers probably produce higher service satisfaction overall than the high-cost insurers, you would expect the latter to be long out of business, but they are not.

The high cost and the inefficiency of insurers are now getting national attention. The monopoly rents this industry has enjoyed can be found in its fat and waste. The insurance industry is headed for a tough period as it adjusts to either a properly regulated or a properly competitive market, following the coming repeal of the antitrust exemption, the onslaught of foreign competitors, and the inevitable entry of banks.

The Antitrust Exemption

Harrington fails to point out that after extensive review, the U.S. Department of Justice under President Ford and President Carter's Antitrust Commission both recommended repeal or amendment of the McCarran-Ferguson antitrust exemption. His paper alleges that rate bureaus no longer produce final rates. This is incorrect. We have only just begun the promised change to "prospective loss costs." In some lines of insurance, final rates are still filed everywhere.

Even if this promise to go to "prospective loss costs" comes to fruition, it will not end the joint speculation about things like next year's inflation rate and other key future factors that should be estimated on a company-by-company basis, if this market is ever to become fully competitive.

Background of the ISO Change

The Insurance Services Office, Inc. (ISO) traditionally has provided insurers with "advisory" rates made up of two parts: pure premiums (or projected loss costs) based on a complex equation formula that incorporates factors such as trending, loss development, inflation, and the like—this represents about 60 percent of the final premium—and a factor to load in expenses and profits representing about 40 percent. The latter factor is determined as a simple single "multiplier" by which the expenses and profits are loaded into the pure premium.

Why the ISO "Change" Is Meaningless

ISO promises to provide only the complex 60 percent part, the pure premium or prospective loss costs. It will provide all the data and calculations except the multiplier to factor in the final 40 percent. But ISO will "help" insurers fill in this one missing blank in the equation by providing training and a circular (a sort of "cookbook") that describes for insurers precisely how to convert the prospective loss cost data into a final rate. Significantly, the one-step multiplication factor used for this purpose means that insurers will continue to rely on ISO trend and loss development data, the key to price-fixing practices. Critical components of the ultimate premium, which should be calculated independently by insurers based on their individual judgment and experience, will continue to be formulated by ISO. Those components include, for example, labor costs, inflation factors, loss adjustment expenses, and so on. Thus, significant price-fixing would continue even under the new ISO approach, even if the insurers do not adopt the method and data needed to calculate the ISO final rate.

In 1985, the *National Underwriter* noted the end of the soft market by reporting that [in general liability] "what has occurred . . . is a return to basic ISO rating subject to a minimum 20 percent surcharge. . ." (pp. 8, 82).

Harrington argues that there is no evidence that the antitrust exemption and the availability of jointly set prices had any impact on the industry relative to the so-called "liability crisis" of the mid 1980s. He is mistaken. As the New York Attorney General testified before Congress on June 3, 1991, evidence exists of collusive price-fixing during that period, but the Attorney General cannot file a lawsuit simply because of the McCarran-Ferguson exemption. Mr. Sampson said:

Our two-year investigation revealed an industry in which collusion is the norm, not the exception. We found numerous anticompetitive acts that would have invited criminal prosecution in any other industry. These included price-fixing schemes of all varieties, market allocation agreements between competitors, and tying arrangements that forced unwilling insurance buyers to purchase unwanted coverages in order to get the coverage

they needed. We could have included these allegations in our lawsuits, and would have done so were it not for the futility of doing so in the face of the McCarran-Ferguson Act.

The climate of collusion we found was a major contributing factor to the insurance crisis of 1985–86. The sharp swings within the industry as a whole were not the result of mere coincidence, but rather evidence of a lockstep mentality and an absence of real competition. Although there were thousands of insurance carriers across the country, the direction of the market was set by precious few companies, the same companies which dominated the industry trade association.

Smaller carriers blindly followed the price hikes and market withdrawals of their largest competitors, emboldened by their trade association leadership who was constantly calling on its members to raise their prices “for the good of the industry.” These factors transformed a gentle swing in the pattern of prices within the industry to an avalanche of destructive pricing conspiracies.

It is of little solace to insurance consumers who were victims of these price-fixing conspiracies that the Attorneys General were finally able, after several years of investigation, to bring antitrust actions alleging boycott, coercion and intimidation. Were this any other industry, without this exemption, we could have also brought price-fixing actions (which are easier to prove than boycott cases), thereby providing consumers with full relief for all of the injuries they suffered. The McCarran-Ferguson Act effectively handcuffs our offices, taking away a large part of our antitrust arsenal.

Because they believe that competition is weakened when price-fixing is allowed, a number of groups support McCarran-Ferguson reform.⁵ Even parts of the insurance industry have decided to work for some changes in the broad exemption to the nation’s normal business rules. The American Insurance Association has shown flexibility and has proposed a safe harbors approach. The Alliance of American Insurers has shown some softening on this issue.

Harrington claims that repeal of the antitrust exemption will not

⁵ These include Small Business Legislative Council; Consumers Union; National Federation of Business and Professional Women’s Clubs (BPW/USA); National Council of Senior Citizens; U.S. Public Interest Research Group; American Federation of Labor—Congress of Industrial Organizations (AFL-CIO); Consumer Federation of America; American Association of Nurse Anesthetists; Texas, Colorado, and Illinois Associations of Nurse Anesthetists; National Insurance Consumer Organization; Consumer Bankers Association; American Association of Retired Persons; Amalgamated Transit Union; Environmental Policy Institute; Environmental Action; Public Citizen’s Congress Watch; National Association of Women Business Owners; Women’s Equity Action League; American Nurses Association; Association of American Physicians and Surgeons; National Association of Attorneys General; American Bankers Association; Business and Professional Women; Citicorp; American Association of University Women; National Women’s Health Network; Federal Trade Commission; American Association of Colleges of Nursing; American Society for Medical Technology; Automotive Service Association; Citizen Action; American Bar Association; Society of Collision Repair Specialists (SCRS); and Older Women’s League.

lower insurance prices. He goes so far as to say that "At worst, it will produce even higher prices." It appears that Harrington has found the secret to lower prices that has eluded all others since Adam Smith—create cartels to lower prices. But, again, he is in error. As the GAO found in 1986 in looking at the results of introducing competition into workers' compensation insurance markets (p. 32):

Four states—Michigan, Illinois, Minnesota, and Oregon—prepared reports on the impact of competitive rating. Each of these states reported substantial declines in the cost of workers' compensation.

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Discussion

*Robert E. Litan**

Scott Harrington has provided an excellent overview of what is, for the most part, the consensus view among academic scholars on the subjects of solvency and rate regulation of the property-liability insurance industry. I agree with most of what he has to say. But I disagree with Harrington's rejection of a role for federal solvency regulation. I also draw some broader lessons from the S&L crisis than Harrington provides in his paper.

State vs. Federal Solvency Regulation

Harrington is generally comfortable with continued state regulation, noting that between 1984 and 1989 guaranty fund assessments totaled less than one-half of 1 percent of nationwide premiums. He also suggests that the four large property-liability insurer failures discussed in Representative John Dingell's *Failed Promises* report may have been due as much to unexpected increases in claims costs as to deliberate under-reserving and underpricing. Accordingly, Harrington apparently finds little fault in state regulation in these cases.

I disagree. In my view, the Dingell report makes a persuasive case that these insurers did understate their loss reserves and did engage in reckless patterns of expansion, activities that state insurance regulators should have caught. The fact that A.M. Best had given these companies high ratings up to the time that regulatory actions were taken is cause

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for criticizing the rating agency, not for excusing state regulators. The same point goes for the accountants who audited these insurers. With the level of losses these insurer failures will ultimately entail, someone in the regulatory agencies had to be asleep at the switch.

In addition, while I agree with Harrington that the insurer insolvency problem is currently not alarming—at least when compared to insolvency costs in the banking and thrift industries, which over the past decade have probably exceeded \$250 billion—by historical standards, the numbers of insurer failures and their costs during the past several years are up sharply. While the general economic climate in both segments of the insurance industry has not been favorable, state regulation cannot escape its share of responsibility for the insolvencies. It is well known that failed insurers generally were poorly managed and apparently in many cases were looted by their managers or owners. At the very least, the regulators could have been far more aggressive in limiting the growth of the “problem” insurers on their watch.

The National Association of Insurance Commissioners (NAIC) has effectively admitted as much and is now implementing an accreditation program for state insurance departments. Although Harrington believes the evidence is unclear, there is no doubt in my mind that the spectre of federal regulation that Dingell has made so real accounts for the NAIC’s sudden “religion” on solvency matters.

Harrington apparently believes that the NAIC’s efforts will prove to be sufficient. The General Accounting Office has recently reached the opposite conclusion, pointing to the weak power the NAIC has over individual state regulators. Dingell apparently agrees, because he is promoting a plan that would require state insurance regulators to meet minimum federal standards. Little support appears to exist, however, for totally replacing state insurance regulators with federal regulators.

I do not advocate such an extreme step either, but I see much more merit in allowing insurers to *choose* federal regulation. Specifically, much as banks have the choice whether to be chartered and regulated by the states or the federal government, insurers could be given a choice whether they want to be regulated, for solvency purposes only—consumer protection would remain with the states—by the states or by the federal government. If they chose the federal option, insurers would join a national guaranty fund system. Equally significant, by choosing the federal option insurers would be free from state rate regulation. And if the McCarran-Ferguson Act has not yet been repealed for all insurers, then the antitrust protection provided in McCarran-Ferguson would not apply, outside of some “safe harbors” for data collection and trending, for federally regulated insurers.

Such an option has at least two important advantages. First, it recognizes what both the NAIC’s accreditation program and Dingell’s minimum standards proposal ignore: the critical link between rate regulation and solvency. Somewhat incredibly, a state can get a sterling

solvency accreditation from the NAIC even though it may have a highly restrictive regime of rate regulation that limits the profitability of all insurers and conceivably forces some to lose money.

The Department of Insurance in California—home to what is to date the largest insurer insolvency in U.S. history, Executive Life—has recently proposed, for example, that property-liability insurers in that state be limited to earning a “reasonable rate of return” on surplus only up to some specified ceilings (set on a line-by-line basis). In testimony that I have just given on behalf of State Farm, I calculated that if applied on a nationwide basis, the California ceilings would mean that the property-liability insurance industry collectively could not earn a market rate of return on approximately \$50 billion of its \$139 billion in surplus. At a time when the public is concerned about the sufficiency of capital in its banking, thrift, and—yes—insurance industries, it is somewhat incredible that any state, let alone the largest one in the country, can even be thinking about adopting policies that would discourage insurers from being well capitalized. And to make this effort even more bizarre, it comes at a time when California’s insurance commissioner has asked the federal government to help rescue policyholders of Executive Life who reside in California.

Given the public concern over mounting insurance costs, it would be surprising if more states did not follow the lead of California and New Jersey and attempt to impose restrictive rate regimes, notwithstanding the criticisms that Harrington and other economists have effectively marshalled against such an approach. Not only will additional rate regulation aggravate the insurance availability problem and contribute to the growth of residual markets, but carried out long enough and on a sufficiently large scale, it will lead to more insurer failures. Such an outcome can be prevented by using the availability of a federal solvency option, coupled with preemption of state regulation, to discipline states that have not yet understood that rate and solvency regulation ultimately are inconsistent.

Second, the national guaranty fund that would be created as part of a federal solvency regulatory scheme would provide more effective protection for policyholders of failed companies. Under the current system, policyholders in each state must look only to the guaranty funds in their states, whose annual assessments on the insurers doing business there are capped, generally in the neighborhood of 1 percent of premiums collected in the state. As a result, state guaranty funds can face significant cash flow constraints when honoring claims of large failed insurers, limitations that can force claims payments to policyholders to be stretched out over time.

A national guaranty fund, even with the same annual assessment caps, would be better able to handle the costs of large insurer failures because it would have a much larger assessment base. While I agree

with Harrington that guaranty fund protection should be curtailed for many commercial policies, I do not see any case for opposing devices that would better ensure that personal policyholder claims are paid on a timely basis rather than spread out over many years.

Admittedly, a significant "adverse selection" problem may occur with a federal solvency option. Other things equal, it would be likely to attract the largest nationwide insurers least in need of the McCarran antitrust protection for joint data collection. The withdrawal of the large companies from the state guaranty funds would leave those funds more exposed to cash flow and perhaps ultimate funding constraints, in the event of large failures of insurers still belonging to the state systems. Over time, as consumers learned of the greater dangers associated with state insurers, business would gravitate to the federal insurers, leaving the states with dwindling regulatory responsibilities.

This pessimistic scenario need not occur, however, if the states fight back by convincing consumers that they, too, have strong solvency regulatory programs. In the process, the states would learn that rate restrictions are antithetical to ensuring solvency. And that is precisely why a federal solvency option might be just the thing that induces the states to avoid or repeal any rate regulation.

Forcing the states to compete with the federal government in regulating insurer solvency might also induce them to look for other, more productive ways to reduce insurance premiums. Specifically, I have in mind proposals for true no-fault auto insurance, which I believe could significantly lower auto insurance premiums, coupled with selective tort reforms that have already lowered liability insurance premiums in the states that have adopted them, as Blackmon and Zeckhauser (1991) have demonstrated.

Broader Lessons from the S&L Crisis

Most reporters, it seems, cannot write about the recent upturn in insurer insolvencies without drawing a comparison to the savings and loan disaster. Similarly, the *Failed Promises* report by the Oversight and Investigations Subcommittee of the House Energy and Commerce Committee begins with a warning that federal policymakers not let happen to the insurance industry what happened to thrifts. Harrington, too, draws a lesson from the S&L crisis: that regulatory forbearance considerably raised the cost of resolving the thrift mess and therefore should not be repeated in the case of insurers.

Ironically, however, Harrington's recommendation that guaranty funds continue to stick with the post-insolvency assessment method of finance could in fact facilitate the forbearance policy he elsewhere abhors. It is true in theory that requiring healthy insurers to pay for

failed insurers after the fact may give them strong incentives to pressure regulators to close or merge troubled insurers on a timely basis. But in fact, as a recent General Accounting Office report (1991) documents, many state insurance regulators have been late closing insolvent insurers, suggesting that the incentives are not as strong as Harrington and others may postulate. One reason why is that, as I have already indicated, the post-insolvency assessments on insurers are capped, typically at 1 to 2 percent of premiums.

Another potentially more important reason, however, is that precisely because insurers' post-insolvency assessments are highly dependent on the pace of insurer closures, state insurance departments that may otherwise be too close to the insurers they regulate may hesitate to close troubled insurers too quickly, for fear of unnecessarily increasing the assessment costs incurred by healthy insurers. If insurers paid fixed assessments on a pre-insolvency basis, like banks, then guaranty funds could build up positive balances and insurance regulators could then proceed to close troubled insurers, safe in the knowledge that the costs of doing so would not change the costs of healthy insurers in that year. Indeed, the reason why thrift regulators engaged in forbearance was that they had insufficient funds to do otherwise. Insurance regulators are in an even worse situation: they have no funds at all unless they raise them after the fact, and even then their annual assessments on healthy insurers are capped by statute.

Of course, I recognize the strong countervailing reasons for continuing with the post-insolvency assessment system. Among them is the danger that guaranty fund surpluses will be raided by state governments eager to avoid running deficits. But if this is the problem with pre-funded guaranty systems, it can be cured by creating a federal guaranty program. Until recently, the FDIC has had ample reserves, invested in Treasury securities to be sure, but still worth 100 cents on the dollar. The same cannot be said of state governments that may raid their insurer guaranty funds and stuff them with state government bonds which, as events are demonstrating, can trade at prices well below 100 cents on the dollar.

Much broader lessons can be learned from the thrift crisis, however, which are not discussed in Harrington's paper but which I believe are central to any effort to prevent future insurer insolvencies. As a number of observers have pointed out, the thrift crisis of the 1980s was, in significant part, the product of major policy errors of the 1970s. Specifically, had Congress adopted the recommendations of the Hunt Commission in the early 1970s to lift deposit interest rate ceilings then and to permit thrifts to extend adjustable-rate mortgages, thrifts would have been far better positioned to have avoided the huge "interest rate shock" of the late 1970s and early 1980s. Rather than being stuck with low-interest fixed-rate mortgages when deposit interest costs soared, thrifts would have had mortgage portfolios with yields much closer to their actual deposit costs.

And by largely avoiding the “maturity mismatch” of the early 1980s, many fewer thrifts would have had their capital depleted, the situation that gave rise to massive “gambling for resurrection” during the rest of the decade when Congress and the Administration failed to provide sufficient funds to close down insolvent institutions.

In short, the thrift crisis was far more than a failure of adequate supervision, or what I would call the “green eyeshade” aspect of solvency regulation. The S&L disaster had its roots in the flawed institutional design of the thrift industry itself—the requirement that thrifts borrow short and then lend long at fixed rates—that cracked when the macroeconomic environment produced double-digit interest rates.

Similarly, I find that much of the current discussion about insurer insolvency is of the “green eyeshade” variety: that we need better supervisors and more of them, and that perhaps the federal government rather than the states should be in charge of supervision. And so on.

Don’t get me wrong. All of these issues are important; after all, I have spent most of my discussion time on them. But ultimately, the gravest dangers to insurer solvency in my view come not from flaws in the supervisory structure, but from major exogenous events for which we as a society—and the insurance industry in particular—are ill-prepared.

One such event is a massive earthquake—with far greater destructive power than the Loma Prieta quake that hit California nearly two years ago—that scientists project is quite likely to strike at some point in the next several decades, not necessarily in California but perhaps near Memphis, Seattle, or any number of other locations around the country. By various estimates, the insured losses from such an event could rise as high as \$50 billion, or enough to wipe out more than one-third of the capital in the property-liability insurance industry.

The second event could be even more devastating: a series of court rulings holding insurers responsible for potentially hundreds of billions of dollars in costs for cleaning up hazardous waste sites. Thus far, insurers appear to have won most of the cases that have been brought on this subject, with courts holding that the “sudden and accidental” exclusion in the general commercial policy means what it appears to say—that commercial policies do not cover continued releases of hazardous substances over many years. Nevertheless, a sufficient number of court rulings go in the other direction to raise the spectre that insurers will have to honor very large environmental claims costs that they surely did not think they were covering when they wrote those policies many years ago.

It is tempting, of course, to say that insurers or policymakers can do nothing now to prevent either of the events I have just described. In a limited sense that is true. No one can prevent the next earthquake. And who knows what juries and judges will decide in future environmental litigations?

Nevertheless, policymakers can take steps now that would substan-

tially minimize insurers' exposure to these events and that are also in the wider public interest. As to earthquakes, policymakers could adopt a federal reinsurance program that primary insurers could use for their exposures to large catastrophic risks, such as a major quake. Such a program could be set up on a fully "pay-as-you-go" basis, although if a quake struck in the early years, the federal government would have to be prepared to lend sufficient funds to the reinsurance corporation to honor claims, with repayment by the insurers required thereafter over an extended period. In addition, earthquake damage costs themselves can be reduced by cost-effective mitigation efforts, which both the states and the federal government can and should encourage.

Meanwhile, for the environmental risks I am sympathetic with the American International Group proposal that would eliminate litigation over responsibility for cleanup of past hazardous waste by establishing a much larger cleanup fund than currently exists. The fund would be financed with a small annual premium tax on all commercial insurance policies and on businesses that self-insure. Such a program would dramatically reduce both the high transactions costs and the long delays that have plagued the hazardous waste cleanup effort for over a decade. In the process, it would also remove the threat of tens (if not hundreds) of billions of dollars of cleanup claims that now hangs over the insurance industry like a Sword of Damocles.

In sum, ensuring solvency in the insurance industry is a task too important to be left just to the auditors and the actuaries. Policymakers, especially those at the federal level, must uncharacteristically think far enough ahead to establish an institutional environment that will allow insurers to remain solvent even in the face of costly adverse events. Failure to do so, I am afraid, may mean far more insolvencies and stranded consumers at some point in the future.

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Discussion

*Richard E. Stewart**

Scott Harrington's paper on "Public Policy and Property-Liability Insurance" addresses two important subjects—rate regulation (including the McCarran-Ferguson Act) and insolvency. I will outline briefly the major issues I see involved in rate regulation, and then focus my remarks on the question of the solvency of casualty insurance companies.

Rate Regulation

While solvency is often considered to be the chief goal of insurance regulation, rate regulation is the subject to which, for over a century, we have actually devoted the most attention. It covers such matters as whether to suppress, tolerate, or encourage competition; whether to allow, support, enforce, prohibit, or have government take over and perform standard development of policy forms, statistics, and rates; and how to balance efficiency and fairness in rate regulation, including questions of cross-subsidy and residual markets.

Today's debates revisit those questions and add others. We are struggling a bit, both because the questions are difficult and because no one brings a broad balance of theory, analysis, history, and explicit social policy. Today's formulation of the rate regulation problem raises several questions.

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How Much to Rely on Competition

This requires that we define the term "competition" and develop a way to measure it. Then we must also decide:

- (1) Whether to expect and allow competition itself to take care of pockets of insufficiency;
- (2) How much to defer to cost-based pricing and whether to defer to industry definitions and categories of cost;
- (3) Whether to discourage certain kinds or amounts of expense by not allowing them in a regulated rate;
- (4) How, if at all, to deal with ability to pay, especially for a line of insurance that is a necessity and whose pricing is regressive; and finally,
- (5) How to think about and deal with the side-effects of rate regulation, such as effects on availability, solvency, and claims.

How to Deal with the Underwriting Cycle

No agreement has been reached among experts about whether or not the underwriting cycle is natural and even inherent in the business. Any determination about this will affect our attitudes about:

- (1) How much interference in the cycle is desirable, manageable, or even possible;
- (2) What to do, at the next cycle turn, with the array of rebound-suppressants now in place, including flex rating laws and multiple-lines joint underwriting associations; and
- (3) What, if anything, can and should be done to bring within prevailing policy about the cycle the impressive array of devices for opting out of conventional insurance and regulation, including self-insurance, captives, and the non-admitted market.

How to Resolve Current Legal Questions

Several major legal questions now command our attention and action, including:

- (1) McCarran-Ferguson Act modification or repeal;
- (2) The federal-state split of responsibility for regulation; and
- (3) The state action doctrine, calling for more intensive rate regulation if McCarran is no longer a basis for state jurisdiction.

Solvency

To an audience of central bankers I would recommend three initial thoughts regarding property-liability or casualty insurance company

insolvency. All three have to do with something's not being something else. First, an insurance company is not a lesser form of bank. Dr. Johnson said a long time ago that being in a ship was like being in prison with the added chance of drowning. Being a casualty insurer is like being a bank with the added chance that your liabilities will get you, too. The second thought follows from the first: When you look at trouble in casualty insurance, it is not really an asset problem. The weakest assets on the balance sheets for casualty insurers are not invested assets; they are trade assets, such as reinsurance recoverables and agents' balances. If you see a casualty insurer with weak invested assets, probably you are looking at a casualty insurer that years ago realized it was in some other kind of trouble and decided to try to break its way out by shooting craps on the left-hand side of the balance sheet. The third initial thought is that the future is not going to be like the past, which is probably a good thing.

With those preliminaries out of the way, I would like to reflect on three large questions still open for discussion in the area of casualty insurance company insolvency: Is insolvency natural or is it culpable? What is the duty of the regulator? And who are the victims and what are we going to do about them?

Insolvency: Natural or Culpable?

It is quite the fashion in financial institution insolvency circles these days to speak in terms of villains. And it is not hard to see why. We are all gardeners, and it is nice to say that everything was fine in the garden until the snake showed up. But it leads to a lot of interesting consequences. One is that everybody close to the situation feels ashamed of it, and another is that an endless circle of recrimination can get started, because a perpetrator can always be found. But in the line of insurance most threatening to the solvency of insurance companies these days, general liability, the threats are indeed systemic.

Think about it for a second. This industry has a large number of participants and used to have, but does not have any longer, a lot of price structuring and support. In some lines, suppression of rates and underwriting can lead to catastrophes on the sales or revenue side. Furthermore, this industry's liabilities are far out in the future, and nearly impossible to estimate for pricing or reserving purposes. The industry's prediction requirements have a lot more in common with long-range weather forecasting than with something simple like predicting interest rates over a five-year period. This leaves the industry susceptible to catastrophes on the liability side. Moreover, the casualty corner of the insurance industry is intensely competitive, usually on price, and buyers have developed an impressive array of ways to opt out

of the conventional insurance and regulatory system whenever they think it is in their business interest to do so.

All this is a recipe for a type of insurance that is going to get in a lot of trouble. The industry is selling a tremendously valuable contract, essentially an open-ended "we will pay you if you are liable" contract. The incentives and rewards for buyers, brokers, and regulators are concentrated on the front end of the insurance transaction, availability and price at the point of sale. At the same time, the pressures on the industry are shifted to the back end of the scale, the willingness and ability to pay claims. In our complex society, from time to time some liability that nobody foresaw comes in over the transom and hits grievously, right across the industry. The hit is essentially nondiversifiable and too late to get into prices. It is very hard to avoid the conclusion that insolvency is a natural outcome of having a private and competitive business handle this kind of activity.

When we think about any industry other than the one we work in, we tend to think that insolvency is a desirable incentive to efficiency, and purgative of those less able to serve the needs of customers. In other words, we think insolvency is a good thing—not fun to have it happen to you, but a good thing that makes the whole show work better. That being said, I believe the whole emphasis needs to change away from the villain theory, not because there are no snakes but because the snakes do not really cause the problem.

The Duty of the Regulator

Our attitude toward insolvency in turn affects how we approach the second question, the duty of the regulator. You would think we would know what it was, but I used to be one, and I was not sure. Here are the competing possibilities. First, it is the duty of the commissioner to prevent insolvencies. That is the usual formulation. But by saying that while at the same time saying that insolvency is a natural, not a culpable outcome, look what happens: you have given the regulator a duty that essentially he cannot perform. It is akin to saying, if a company goes insolvent on your watch, fella, you are probably one of the snakes. Early detection and swift action to take failing companies out of the market are best in principle, but hard to do in individual cases. It is not too hard, however, to avoid recognizing insolvency if the problem is coming from a kind of insurance with a 10- or 20-year time dimension and highly inexact estimates of losses and therefore liabilities. It is no great trick to maneuver over, say, a five-year span when a company is going to go in any event, which normally means your successor will be in office. We should not surround public servants, or private servants for that matter, with that kind of incentive unless we expect them to respond to it.

So, if the duty of insurance regulators is to prevent insolvency, but

in a circumstance where they no longer can do so, since the future is not going to be like the past, we are just asking people to forbear, to put off the recognition of the bad news. And in the later years of a failing insurance company, the risks go up rather like the mortality curve in life insurance, because management has to bet in worse and worse games.

Aid for the Victims

A third open question worth our attention is the action to aid the victims of insurance insolvency. In the United States, we have decided to run a large part of our system of financial compensation for accidents through an insured civil liability system: a bad idea or good idea, but we have chosen it. And people all over the place rely on it. Some of them are the buyers of insurance who pick the insurance company and rely on it for indemnity from the liability that the law places upon them. But our society also includes a large ring of other people who did not know any of this was going on and who ended up the victims of some mishap, call it asbestosis, for which our legal system says that they have redress, against somebody. Those people are widely dispersed, but in a society whose rules include product liability, pollution liability, directors' and officers' liability, and a lot of other kinds of liability, a single policyholder can have a single course of conduct with a hundred thousand injured people. That means that a group of diffuse and somewhat invisible and unorganized people can be terribly hurt by the insolvency of an insurer, on whom part of this system depends. It is inherent in the dual role of our liability insurance system, indemnity and compensation. It just has to be faced. It is not just major corporate America that we would be socking it to if we withdrew one or another protection surrounding the insurance system.

In the past, the big decisions about risk and resource allocation in insurance were made by executives, bureaus, state legislatures, state regulators, and private forums such as arbitration. Today authority is dispersed, and the decision-makers include lawyers, courts (setting limits on rate regulation and making financial failure a new *prima facie* tort), consumers (especially political constituencies and corporate risk managers), and federal officials (both making markets easier and expressing alarm about solvency). This means that decision-making forums with divergent methods and objectives will compete to make the big decisions about insurance resource allocation (including insolvency risk), with the outcome unclear and perhaps out of control for a long time. Two groups stand to suffer most if we take no action now to deal with the current situation: first, the victims of mass torts who have legal claims against an insured person; and second, the small insurance companies, which will be least able to keep customer confidence during

a substantial period of uncertainty about whether the whole insurance market can be relied upon.

In the past three years our firm has written two reports on this subject.¹ Both consider the causes of insolvency, and the second one gets into what we think should be done about it, specifically in the design of guarantees. Our own view is that, in an imperfect world, where we have inherited most of our private and governmental institutional arrangements from the past but must deal with the present, the best thing to do obviously is to change some of these perceptions about natural or culpable insolvency and the duty of the regulator. If the duty is to take the dangerous person off the street like a cop, not to hold him in your arms like an emergency physician, then the duty of the regulator is early detection and swift action to take the failing company out of the market. That duty would include protecting innocent victims with a limited system of guarantees.

We believe further that the first two, detection and action, can be done well by the state regulators of insurance, and they will be doing it better as they pursue the changes that they are embarked upon now. About the third, liquidation and guarantees, for general liability insolvencies of the magnitude that generate victim suffering of the sort I was describing—insolvencies that are large, complex, time-consuming and certainly national—we believe they should be managed at the national level. But whatever we do, we ought to be clear about what it is that we are doing, and we ought to be reasonably quick about it.

¹ Stewart Economics, Inc. "Managing Insurer Insolvency" (1988) and "Insurance Insolvency Guarantees" (1990).