

Risk Management

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MGM510

Lec.8 : Government Regulation of Insurance



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“There are serious shortcomings in state laws and Regulatory activities with respect to protecting the interests of insurance consumers.”

U.S. Government Accountability Office.”



Lecture objectives

After studying this chapter, you should be able to:

- ❖ Explain the major reasons why insurers are regulated.
- ❖ Identify key legal cases and legislative acts that have had an important impact on insurance regulation.
- ❖ Identify the major areas of insurance that are regulated.
- ❖ Explain the objectives of rate regulation and the different types of rating laws.
- ❖ Explain the major arguments for and against state regulation of insurance.
- ❖ Describe some approaches for modernizing the regulation of insurance..

Reasons for Insurance regulation

To protect consumers, the governments regulate the market activities of insurers. Major reasons for the regulation of insurance include the following:

- ❖ Maintain insurer solvency
- ❖ Compensate for inadequate consumer knowledge
- ❖ Ensure reasonable rates
- ❖ Make insurance available

Maintain insurer solvency

Insurance regulation is necessary to maintain the solvency of insurers. Solvency is important for several reasons.

- ❖ First, premiums are paid in advance, but the period of protection extends into the future.
- ❖ A second reason is that individuals are exposed to great economic insecurity if insurers fail and outstanding claims are not paid.
- ❖ Finally, when insurers become insolvent, certain social and economic costs are incurred.

Compensate for Inadequate Consumer Knowledge

- ❖ Regulation is also necessary because of inadequate consumer knowledge. Insurance contracts are technical, legal documents that contain complex clauses and provisions. Without regulation, an unscrupulous insurer could draft a contract so restrictive and legalistic that it would be worthless.
- ❖ It is difficult to compare dissimilar policies with different premiums because the necessary price and policy information is not readily available.

Compensate for Inadequate Consumer Knowledge

- ❖ Without good information, consumers cannot select the best insurance product. This failure can reduce the impact that consumers have on insurance markets as well as the competitive incentive of insurers to improve product quality and lower price. Thus, regulation is needed to produce the same market effect that results from knowledgeable consumers who are purchasing products in highly competitive markets.
- ❖ Finally, some agents are unethical, and state licensing requirements in many states are minimal. Thus, regulation is needed to protect consumers against unscrupulous agents.

Ensure Reasonable Rates

- ❖ Regulation is also necessary to ensure reasonable rates. Rates should not be so high that consumers are being charged excessive prices.
- ❖ Regulation also protects consumers against some insurers who may attempt to increase rates to exorbitant levels after a natural disaster occurs so as to recoup their underwriting losses.

Methods for Regulating Insurers

❖ Three principal methods are used to regulate insurers: [legislation](#), [courts](#), and [state insurance departments](#).

❖ [Legislation](#)

All states have insurance laws that regulate the operations of insurers. These laws regulate (1) formation of insurance companies, (2) licensing of agents and brokers, (3) financial requirements for maintaining solvency, (4) insurance rates, (5) sales and claim practices, (6) taxation, and (7) rehabilitation or liquidation of insurers.

Methods for Regulating Insurers

Courts

- ❖ State and federal courts periodically hand down decisions concerning the constitutionality of state insurance laws, the interpretation of policy clauses and provisions, and the legality of administrative actions by state insurance departments. As such, the court decisions can affect the market conduct and operations of insurers in an important way.

Methods for Regulating Insurers

State Insurance Departments

- ❖ Through administrative rulings, the state insurance commissioner wields considerable power over insurers doing business in the state. The insurance commissioner has the power to hold hearings, issue cease-and-desist orders, and revoke or suspend an insurer's license to do business.

What Areas are Regulated?

Insurers are subject to numerous laws and regulations. The principal areas regulated include the following:

- ❖ Formation and licensing of insurers
- ❖ Solvency regulation
- ❖ Rate regulation
- ❖ Policy forms
- ❖ Sales practices and consumer protection
- ❖ Taxation of insurers

Formation and Licensing of Insurers

All states have requirements for the formation and licensing of insurers. A new insurer is typically formed by incorporation.

- ❖ A license can be issued to a domestic, foreign, or alien insurer. A domestic insurer is an insurer domiciled in the state; it must be licensed in the state as well as in other states where it does business.
- ❖ A foreign insurer is an out-of-state insurer that is chartered by another state; it must be licensed to do business in the state.
- ❖ An alien insurer is an insurer chartered by a foreign country.

Solvency Regulation

- ❖ **Admitted Assets:** Insurers are required by law to file certain financial statements in an annual report to regulators.
- ❖ **Admitted assets** are assets that an insurer can show on its statutory balance sheet in determining its financial condition. All other assets are non-admitted assets.
- ❖ **Reserves** are liability items on an insurer's balance sheet and reflect obligations that must be met in the future.
- ❖ **Surplus:** The surplus position is also carefully monitored.
- ❖ **Policyholders' surplus** is the difference between an insurer's assets and its liabilities

Risk-Based Capital

- ❖ To reduce the risk of insolvency, life and health insurers must meet certain risk-based capital standards based on a model law developed by the NAIC.
- ❖ Risk-based capital (RBC) means that insurers must have a certain amount of capital, depending on the riskiness of their investments and insurance operations. Insurers are monitored by regulators based on how much capital they have relative to their risk-based capital requirements.



Risk-Based Capital

- ❖ The risk-based capital requirements in life insurance are based on a formula that considers four types of risk:
 1. **Asset risk.** Asset risk is the risk of default of assets for affiliated investments; the parent company must hold an equivalent amount of risk based capital that provides protection against the financial downturn of affiliates.
 2. **Insurance risk.** Insurance risk is the equivalent of underwriting risk and reflects the amount of surplus needed to pay excess claims because of random fluctuations and inaccurate pricing for future claim levels.

Risk-Based Capital

3. **Interest rate risk.** Interest rate risk reflects possible losses due to changing interest rates. The impact of interest rate changes is greatest on those products where the contractual guarantees favor the policyholders and where policyholders are likely to respond to changes in interest rates by withdrawing funds from the insurer.

4- **Business risk.** Business risk represents the wide range of general business risks that life insurers face, such as guaranty fund assessments and insolvency because of bad management.

Investments

- ❖ **Investments:** Insurance company investments are regulated with respect to types of investments, quality, and percentage of total assets or surplus that can be invested in different investments. The basic purpose of these regulations is to prevent insurers from making unsound investments that could threaten the company's solvency and harm policyholders.
- ❖ **Dividend Policy:** In life insurance, the annual gain from operations can be distributed in the form of dividends to policyholders, or it can be added to the insurer's surplus for present and future needs.
- ❖ **Reports and Examinations:** Annual reports and examinations are used to maintain insurer solvency.
- ❖ **Liquidation of Insurers:** If an insurer is financially impaired, the state insurance department assumes control of the company.

Rate Regulation

The principal types of rating laws are the following:

- ❖ Prior-approval laws
- ❖ Modified prior-approval law
- ❖ File-and-use law
- ❖ Use-and-file law
- ❖ Flex-rating law
- ❖ State-made rates
- ❖ No filing required

Prior-approval laws

- ❖ Prior-Approval Law Under a prior-approval law, rates must be filed and approved by the state insurance department before they can be used.
- ❖ Insurers have criticized prior-approval laws on several grounds.

Modified Prior-Approval Law

- ❖ Under a modified prior-approval law, if the rate change is based solely on loss experience, the insurer must file the rates with the state insurance department, and the rates may be used immediately (i.e., file-and-use).

File-and-Use Law

- ❖ Under a file-and-use law, insurers are required only to file the rates with the state insurance department, and the rates can be used immediately.
- ❖ Regulatory authorities have the authority to disapprove the rate filing if it violates state law.

Use-and-File Law

- ❖ A variation of file-and-use is a use and-file law. Under this law, insurers can put into effect immediately any rate changes, but the rates must be filed with the regulatory authorities within a certain period after first being used, such as 15 to 60 days..

Flex-Rating Law

- ❖ Under a flex-rating law, prior approval of rates is required only if the rate increase or decrease exceeds a specified range. Rate changes of 5 to 10 percent are typically permitted without prior approval.

State-Made Rates

- ❖ A few states prescribed state made rates that apply to a small number of specialized lines. The state determines the rates, forms, and classifications that insurers must follow. However, insurers are permitted to deviate from state-prescribed rates with the approval of the state regulator.

State-Made Rates

- ❖ No Filing Required Under the no filing required system, insurers are not required to file their rates with the state insurance department. However, insurers may be required to furnish rate schedules and supporting data to state officials..

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Sales Practices and Consumer Protection

- ❖ The sales practices of insurers are regulated by laws concerning the licensing of agents and brokers, and by laws prohibiting twisting, rebating, and unfair trade practices.

Licensing of Agents and Brokers

- ❖ All states require agents and brokers to be licensed. Depending on the type of insurance sold, applicants must pass one or more written examinations. The purpose is to ensure that agents have knowledge of the state insurance laws and the contracts they intend to sell.

Sales Practices and Consumer Protection

Unfair Trade Practices

- ❖ Insurance laws prohibit a wide variety of unfair trade practices, including misrepresentation, twisting, rebating, deceptive or false advertising, inequitable claim settlement, and unfair discrimination.

Twisting

- ❖ All states forbid twisting. **Twisting** is the inducement of a policyholder to drop an existing policy and replace it with a new one that provides little or no economic benefit to the client.

Sales Practices and Consumer Protection

Rebating

- ❖ Rebating is giving an individual a premium reduction or some other financial advantage not stated in the policy as an inducement to purchase the policy..

Complaint Division

- ❖ State insurance departments typically have a complaint division or department for handling consumer complaints. The department will investigate the complaint and try to obtain a response from the alleged offending insurer or agency

Publications and Brochures

- ❖ State insurance departments typically provide a wide variety of publications and brochures for consumers.

Advantages of Federal Regulation

- ❖ Uniform government laws and regulations
- ❖ More effective negotiations of international insurance agreements.
- ❖ More effective treatment of systemic risk. **Systemic risk** is the risk of collapse of an entire system or entire market due to the failure of a single entity or group of entities that can result in the breakdown of the entire financial system.
- ❖ Greater efficiency of insurers.

Advantages of State Regulation

- ❖ Quicker response to local insurance problems.
- ❖ Increased costs from dual regulation.
- ❖ Poor quality of federal regulation.
- ❖ Promotion of uniform laws by NAIC.
- ❖ Greater opportunity for innovation
- ❖ Unknown consequences of federal regulation

Shortcomings of State Regulation

- ❖ Inadequate protection of consumers.
- ❖ Improvements needed in handling complaints
- ❖ Inadequate market conduct examinations.
- ❖ Insurance availability.
- ❖ Regulators overly responsive to the insurance industry.

Current Issues in Insurance Regulation

The insurance industry is part of the overall financial services industry and should not be viewed in isolation when regulation is discussed. Important regulatory issues include the following:

- ❖ Modernizing insurance regulation.
- ❖ Insolvency of insurers regulation.
- ❖ Market conduct regulation.

Methods of Ensuring Solvency

The principal methods of ensuring insurer solvency include the following:

- ❖ Capital standards.
- ❖ Risk-based capital standards.
- ❖ Reserve requirements
- ❖ Restrictions on investments
- ❖ Annual financial statements.
- ❖ Field examinations.
- ❖ Early warning system.
- ❖ FAST system. (Financial Analysis Solvency Tracking) that prioritizes insurers for additional analysis.

Market Conduct Regulation

- ❖ Market conduct refers to the marketing practices of insurers and agents that involve interaction with insureds, claimants, or consumers.
- ❖ Federal Insurance Office (FIO) made the following recommendations concerning the regulation of the market conduct of insurers and agents:
 - ❖ Marital status.
 - ❖ Product approval.
 - ❖ Sales of annuities to suitable purchasers.
 - ❖ Market conduct regulation.
 - ❖ Rate regulation.
 - ❖ Risk classification.



Thank You