

## INTRODUCTION TO INSURANCE REGULATION (201-1)

EO 1. **REGULATION** has a variety of definitions.

**The text provides this definition:** “The supervision and control of an activity for a well-developed purpose by an entity that is *not* directly involved in or party to the activity.”

**The supervision, control, and purpose of regulation evolve as the activity and the environment change.**

**THE CHARACTERISTICS OF REGULATION include an activity’s supervision and control**

1. by an entity *not* directly involved in the activity;
2. for a stated purpose; *and*
3. that evolve.

**THE REGULATORY SYSTEM includes the**

1. **regulatory agency**--the government entity responsible for controlling an activity;
2. **legislature**--which grants regulatory authority to the agency;
3. **executive branch**--which determines who heads the agency;
4. **courts**--which enforce the regulations; *and*
5. **regulated**--the firms, consumers, and other interest groups.

The primary insurance regulatory agency is the state department of insurance, which receives its authority from laws passed by its state legislature.

EO 2. **REGULATION AS A CONTROLLING AND CORRECTING MECHANISM:**

**The regulatory system is divided into two groups:**

1. **entities that control**--the regulatory agency, courts, legislatures, and the executive and judicial branches *and*
2. **entities that are controlled**--firms, consumers, and other interest groups.

The regulators are independent from the market entities and are influenced by different events.

**REGULATION AS A MARKET PARTICIPATION:** The courts, the legislature, and the executive and judicial branches control the market, but remain outside the market.

The regulatory agency becomes a market participant and is affected by the same market influences as the regulated entities.

**State insurance departments control the market by** approving rates; licensing agents, brokers, and insurers; *and* regulating the types of assets and investments held by insurers.

**State insurance departments participate in the insurance market** when court decisions and legislative proceedings affect how regulation is performed and when they compete for skilled employees.

EO 3. **THEORIES OF REGULATION:**

I. **Economic theories**--view regulation as a force that affects and is affected by the market *and* as a way of addressing market imperfections.

A. **Public interest theories**--view regulation as a way to protect the public’s interest in market transactions.

**Public interest is characterized by** a large part of the public being affected by the activity *and* a regulatory goal that is important to the public.

Regulation is necessary to protect the public from market failure.

B. **Public choice theories**--view regulation as the result of the lobbying efforts of powerful market forces.

1. **Capture theory**--holds that entities subject to regulation use the regulatory mechanism for their own purposes (increased profit and reduced competition), *not* to promote the public interest.

**Regulatory policies might include** direct subsidies of money, control over entry of new rivals, control over substitutes for goods and services, *and* price fixing.

2. **Political support theory**--holds that regulators try to maximize political support by promoting policies that favor the interest groups with the most influence.

Regulators seek to allocate benefits to maximize their political returns.

**Price regulation may produce a subsidizing structure**, in which one group of consumers pays more to fund benefits for another group.

**Internal subsidization** uses profits from a successful product or department to fund less profitable products or departments.

3. **Conflict minimization theory**--holds that regulatory policy is influenced directly by pressure from regulated groups and indirectly by limits imposed by the legislature and courts.

Regulation passively balances those pressures.

**Example:** Utility and insurance regulators balance a competitive rate of return for stockholders against the cost to consumers.

4. **Bureaucratic theory**--holds that regulators implement regulatory policy in their own self-interests when they come from or expect to later enter into the industry they regulate.

II. **Political theory of regulation**--views regulation as a political process with political goals influenced by special interests (**political institutions**).

Regulators are active participants with their own goals.

**Four major political institutions (political actors) create regulatory policy:** the regulatory agency, the regulated industry, nonindustry interests (consumer groups), *and* political elites (legislators, chief executives, and judges).

**Critical factors in policy development include**

A. **saliency** (the degree to which people feel affected by and think the political system can address the issue) *and*

B. **complexity** (the amount of specialized knowledge needed to understand the issue).

**Political actors find salient issues more compelling, such as** insurance availability and affordability, detection and prevention of fraud, national catastrophe plans, risk-based capital, a producer database, *and* a continuing education clearinghouse.

**THREE THEORIES OF REGULATION APPLIED TO THE INSURANCE INDUSTRY--**

1. **Public interest theory:** Regulation is justified because it is in the public interest to maintain insurer solvency.

2. **Bureaucratic theory:** Insurance commissioners often work in the insurance industry as consultants or attorneys after they leave their regulatory posts.

3. **Political theory: The system includes**

a. **a regulatory agency** (state insurance department),

b. **a regulated industry** (insurers and some other interest groups such as agents' associations),

c. **nonindustry interests** (consumer groups and some other interest groups), *and*

d. **political elites** (legislators, chief executives, and judges).

The insurance industry has the greatest influence on regulatory policy, followed by insurance regulators.

Political elites have an indirect influence on regulatory policy.

Consumer groups are least involved with regulation, though their involvement is increasing.

EO 4. **JUSTIFICATIONS FOR REGULATING THE INSURANCE INDUSTRY:**

1. **to protect consumers**--who lack complete information about insurance *and*
2. **to maintain insurer solvency**--to make sure insurers can pay the claims for which they are responsible under their policies.

EO 5. **MARKETS:** A **market** is a collection of buyers and sellers of goods and services.

The collection can be subdivided into smaller groups. **Four characteristics of markets:**

1. Ownership rights in goods or services that willing sellers transfer to willing buyers.
2. A stable monetary unit with predictable purchasing power.
3. Freedom to buy or sell goods and services.
4. Inability of any buyer or seller to control the market price.

*[The insurance market: Insurers have ownership rights in the policies they sell to insureds who buy the rights to the promises in the policies. Premiums are expressed in US dollars.*

*Insurance purchases and sales are mostly voluntary--other than mandatory purchases such as personal auto liability insurance.*

*Prices reflect the costs of insuring losses **and** the supply of and the demand for insurance.*

*Entities involved in insurance regulation include insurance regulators, courts, state legislatures, Congress, the executive branches of state and federal governments, the insurance industry, **and** consumers.]*

**THE CHARACTERISTICS OF PERFECTLY COMPETITIVE MARKETS:**

1. **Many buyers and sellers**--none of whom is able to control the price.
2. **Homogeneous products**--so buyers do not develop brand loyalty but instead buy on price.
3. **Perfect information**--by market participants about goods and services.
4. **Easy entry into and exit from the market**--with no significant barriers to buyers or sellers.

**IMPERFECT COMPETITION** arises when sellers [*or buyers*] have **market power** (the ability to charge *more* for goods and services than their production costs plus a competitive return on investment).

**SIX CHARACTERISTICS OF NONCOMPETITIVE MARKETS:**

1. **Few sellers**--which creates the opportunity for sellers to collaborate in setting higher prices or for one seller to act as a market leader.
2. **Nonhomogeneous goods and services**--with perceived differences that create brand loyalty.
3. **Imperfect information**--which induces buyers to pay more than competitive market prices for goods and services. Imperfect information can lead to underpricing of policies and **adverse selection**, the tendency for those with the greatest probability of loss to buy the most coverage.
4. **Barriers to market entry or exit**--created by high capital costs or regulatory limits.
5. **Existence of a natural monopoly**--a single firm that can produce a good or service at a lower cost than two or more firms can when competing.
6. **High transportation, transaction, and information costs**--that give market power to sellers who are close to their customers.

**MARKET FAILURE** (inefficient allocation of resources) results from imperfect competition *and* from **externalities** (the costs and benefits of goods and services that are borne by people who are not involved in the buy-sell transactions). *Examples:* When a company closes, its community faces an empty building, a lower tax base, and increased unemployment.

When you use The Burnham System, your children benefit from the extra time you have for them.

**Externalities in the insurance market include**

1. social insurance and social programs that pay some of the costs *and*
2. classification plans in which the better risks in the group subsidize the poorer risks.

## **REMEDIES FOR IMPERFECT COMPETITION AND MARKET FAILURE:**

1. **Improve the market--**
  - a. **Change the market**--so all information about costs and benefits is incorporated into the prices of goods and services.
  - b. **Extend property ownership**--assign ownership of **public goods** (public property that doesn't belong to any individual person or entity, such as bridges and highways) to private parties who then treat them with the care of ownership.
  - c. **Internalize costs and benefits**--incorporate **externalities** (social costs and social benefits) in market prices.  
(*Example:* Impose pollution taxes.)
2. **Have government intervene--**
  - a. **Apply price controls**--so rates aren't excessive, inadequate, or unfairly discriminatory *and*
  - b. **Impose or remove barriers to market entry**--collect tariffs and premium taxes or eliminate or lessen financial standards.

**Insurance regulation is used to**

  - a. control price and type of product,
  - b. prohibit specific activities,
  - c. improve access to information, *and*
  - d. create barriers to market entry or exit.