**PRINCIPLES OF RISK MANAGEMENT AND INSURANCE**

**CLASS NOTES**

## Chapter 27 Government Regulation of Insurance

Topics

- Reasons for Insurance Regulation
- Historical Development of Insurance Regulation
- Methods for Regulating Insurers
- What Areas are Regulated?
- State versus Federal Regulation
- Current Problems and Issues in Insurance Regulation

Reasons for Insurance Regulation

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

Methods of Regulating Insurers

- The three principal methods of regulating insurers are:
  - Legislation, through both state and federal laws
  - Court decisions, e.g., interpreting policy provisions
  - State insurance departments
    - Every state has an insurance commissioner, who administers state insurance laws
    - The National Association of Insurance Commissioners meets periodically to discuss industry problems and draft model laws

What Areas Are Regulated?

- All states have requirements for the formation and licensing of insurers
  - Licensing includes minimum capital and surplus requirements
  - A domestic insurer is domiciled in the state
  - A foreign insurer is an out-of-state insurer that is chartered by another state, but licensed to operate in the state
  - An alien insurer is an insurer that is chartered by a foreign country, but is licensed to operate in the state
- Insurers are subject to financial regulations designed to maintain solvency
  - Assets must be sufficient to offset liabilities
    - Admitted assets are assets that an insurer can show on its statutory balance sheet in determining its financial condition
  - States have regulations that address the calculation of reserves
  - An insurer's surplus position is carefully monitored by state regulators

What Areas Are Regulated?

  - Life and health insurers must meet certain risk-based capital standards
    - A risk-based capital (RBC) standard means that insurers must have a certain amount of capital, depending on the riskiness of their investments and insurance operations
    - An insurer's RBC depends on:
      - Asset risk
      - Underwriting risk
      - Interest rate risk
      - Business risk
    - A comparison of the company's total adjusted capital to the amount of required risk-based capital determines whether company or regulatory action is required
  - The purpose of investment regulations is to prevent insurers from making unsound investments that could threaten the company's solvency and harm the policyowners
    - Laws generally place a limit on the proportion of assets in a specific asset category, such as real estate
  - Many states limit the amount of surplus a participating life insurer can accumulate, rather than pay as dividends
  - Each insurer must file an annual report with the state insurance department in the states where it does business
  - The state insurance department assumes control of insurance companies that they determine to be financially impaired
    - All states have guaranty funds that provide for the payment of unpaid claims of insolvent property and casualty insurers
    - States have guaranty laws and guaranty associations that pay the claims of policyowners of insolvent life and health insurers
    - The assessment method is the major method used to raise the necessary funds to pay unpaid claims

- Rate regulation takes a variety of forms across states
  - Forms of rate regulation for property and casualty insurance include:
    - Prior approval law
    - Modified prior approval law
    - File-and-Use law
    - Use-and-File law
    - Flex Rating law
    - State made rates
    - Open Competition
  - Many states exempt insurers from filing rates for large commercial accounts
  - Life insurance rates are not directly regulated by the states
- State insurance commissioners have the authority to approve or disapprove new policy forms before the contracts are sold to the public
- Sales practices are regulated by the laws concerning the licensing of agents and brokers
  - All states require agents and brokers to be licensed
  - Insurance laws prohibit a variety of unfair trade practices, such as misrepresentation, twisting, and rebating

- Twisting is the inducement of a policyowner to drop an existing policy and replace it with a new one that provides little or no economic benefit to the client
- Rebating is the practice of giving an individual a premium reduction or some other financial advantage not stated in the policy as an inducement to purchase the policy

State versus Federal Regulation

- Advantages of state regulation include:
  - Greater responsiveness to local needs
  - Promotion of uniform laws
  - Greater opportunity for innovation
  - Unknown consequences of federal regulation
  - Decentralization of political power

- Shortcomings of state regulation include:
  - Inadequate protection against insolvency
  - Inadequate protection of consumers
  - Improvements needed in handling complaints
  - Inadequate market conduct examinations
  - Insurance availability
  - Regulators may be overly responsive to the insurance industry

Current Problems and Issues in Insurance Regulation

- Insolvency of insurers continues to be an important regulatory concern
  - Reasons for insolvencies include:
    - Inadequate rates
    - Inadequate reserves for claims
    - Rapid growth and inadequate surplus
    - Problems with affiliates
    - Overstatement of assets
    - Alleged fraud
    - Failure of reinsurers to pay claims
    - Mismanagement
    - Catastrophic losses
- An increasing number of insurers are using a credit-based insurance score for underwriting
  - Proponents argue:
    - There is a high correlation between an applicant's credit record and future claims experience
    - Underwriting and rating can be more objective and consistent
  - Critics argue:
    - The use of credit data in underwriting or rating discriminates against certain groups
    - Credit reports often contain errors that can harm insurance applicants
    - Credit-based scoring is socially unacceptable

*Assignment: Apply the topic on Rwanda.* *End./.*