# MICHIGAN'S INSURANCE INDUSTRY:

# NEW DIRECTIONS

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# MICHIGAN'S INSURANCE DEREGULATION:

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**Gary Wolfram**

### EXECUTIVE SUMMARY

With the coming of the administration of Republican Governor John Engler in 1991, Michigan's history of government interference in the insurance industry took a distinct change in direction. While there has not been a raft of new legislation or reduction in taxes on the insurance industry, there has been a change in attitude toward the industry by the Insurance Bureau. Rather than seeing the industry as a tool for government policy, the Bureau now sees it as a key part of the market economy, ensuring that resources are allocated efficiently.

Government regulatory agencies often become dominated by persons who either believe in regulation by government or find regulation to their advantage. Governor Engler's appointment of D. Joseph Olson, an outspoken advocate of insurance deregulation (and deregulation in general), as Commissioner of Insurance sent a strong signal that market principles would now serve as the basis for the state's oversight of the industry. Through aggressive using of the tools of the Commissioner and by clearly articulating the limited role of government in the market process, Olson was able to advance significantly the process of deregulation during his tenure from April 1995 to August 1997.

The primary tools he used were advocacy of legislation that reduces government interference in the market, use of the formal rule-making process to clarify legislation, issuance of orders where the commissioner is granted authority by the legislature, and informal administrative processes, such as bulletins, guidelines, and internal memoranda. In addition, strong leadership by a commissioner with a vision transformed the attitude of the bureaucracy and turned the tide of overreaching regulation.

During the Engler administration, legislation to significantly modify the onerous price-fixing regulations of the Essential Insurance Act was enacted, as well as bills that limited non-economic damages for pain and suffering and corrected onerous federal court decisions expanding federal intrusion into the McCarran-Ferguson arena. Taxation of insurance companies ceased being a constant threat posed all the administration, and insurance companies actually received a small tax cut as part of the general reduction in business taxes. Commissioner Olson made extensive use of his power over rulings, filings, and bulletins to reduce government intervention in the insurance market and to reduce compliance costs of insurance companies. Commissioner Olson also worked to thwart the efforts of the National Association of Insurance Commissioners to nationalize a philosophy of extensive regulation of insurance markets.

Other states may learn specific lessions from the Michigan experience, such as the use of the commissioner's power to reduce or eliminate rate filings. The primary lesson, however, is that ideas have consequences. If legislators and administration officials have the courage of their convictions and can articulate the benefits of the market process over central planning, then the tide can be turned in favor of free market principles.

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## INTRODUCTION

Michigan has had a history of government interference in the insurance industry, both to enact social programs and to raise tax revenue. With the administration of Republican Governor John Engler that began in 1991, however, there has been a distinct change in direction, which may be characterized by the title of the Jimmy Buffett song, "Changes in Attitudes, Changes in Latitudes." While there has not been a raft of new legislation or a reduction in taxes on the insurance industry, there has been a change in attitude toward the industry by the Insurance Bureau. Rather than seeing the industry as a tool for government policy, the Bureau sees it as a key part of the market economy that ensures that resources are allocated efficiently. D. Joseph Olson, an insurance executive with a strong understanding of free-market philosophy, illuminated the course towards competitive markets during his term as Commissioner of Insurance in Michigan.

*There has been a change in attitude toward the industry by the Insurance Bureau.*

As George Stigler pointed out many years ago, regulatory agencies will eventually be taken over by those who are being regulated.[1] This finding should be common sense to anyone who is familiar with the literature on rent seeking, the study of how and why people will attempt to use the political system to gain profits.[2] Once the rules of the game are that the government can set the terms of trade and determine who can engage in trade, then it makes sense for people to try to influence the regulators. Eventually some, or even most, existing firms find it in their best interest to have a regulatory system that benefits them and discourages entry into the industry. The regulatory agencies become made up of persons who either believe in regulation by government or find regulation to their advantage. This makes it difficult for the head of any regulatory body to go against the grain and push for deregulation. He or she will be opposed by other regulators, by much of the bureaucracy who makes up their staff, and even the firms that make up the industry.

Commissioner Olson's appointment and his tenure from April 1995 to August 1997 are particularly interesting for two reasons. First, Governor Engler appointed as Commissioner of Insurance an outspoken advocate of insurance deregulation (and deregulation in general). Second, Olson was able to advance

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[1] George Stigler, *The Citizen and the State: Essays on Regulation* (Chicago : University of Chicago Press, 1975).

[2] See Robert Tollison, "Rent Seeking: A Survey," *Kyklos*, Vol. 35 (Fasc.4, 1982), pp. 575-602.

significantly the process of deregulation during his tenure. This paper will examine insurance regulation under the Engler administration with, special emphasis on the tenure of Joe Olson as Commissioner of Insurance.

## REGULATORY REFORM: THE ROLE OF INSURANCE COMMISSIONER

Regulatory reform can take place in a number of areas. The highest profile area is legislative change — enacting new statutes and amending or repealing old ones. An insurance commissioner can act only as an advocate in this area. He can use his expertise to influence the position of the governor and to lobby the legislature. He can use the commissioner's office to make speeches, write articles, and otherwise attempt to influence public opinion. He cannot introduce bills, review them in committee, or vote on them.

*Rather than seeing the industry as a tool for government policy, the Bureau sees it as a key part of the market economy.*

A second area for regulatory reform involves the formal rules issued or rescinded by a commissioner. The commissioner has more potential control in this area, but his ability to act is limited by the requirement that a number of people approve the rules as to substance or form. The most obvious requirement is that regulatory rules cannot conflict with legislation — they can only implement legislation.

A third area is the issuance of orders in areas where the commissioner has been granted some discretion by the legislature. Issuing orders is one of the most direct ways the commissioner can influence the regulatory environment. The constraints here tend to be political. Orders also may be susceptible to legal challenge by parties that are disadvantaged by them.

More informal administrative processes include the issuance of guidelines, bulletins, and internal memoranda. In this area, the commissioner has the greatest room to influence the regulatory climate.

In carrying out an agenda of regulatory reform, a commissioner can have influence in two more areas. First, he can help shape the attitudes and motivation of the deputies and employees that carry out the commissioner's policy. Second, how and what a commissioner communicates to regulated agencies, to politicians, to the other insurance commissioners of the various states, and to the public in general can improve the climate for regulatory reform.

## ATTITUDE OF THE BUREAUCRACY

By appointing D. Joseph Olson as Commissioner of Insurance on April 4, 1995, Governor Engler sent a message to the insurance community about the direction his administration was taking on insurance regulation. Commissioner Olson has expressed his basic operating principle as the following:

> The basic premise of Anglo-American jurisprudence is that, if the law does not prohibit a private person from taking a particular action, he is allowed to do so. On the other hand, if the law does not authorize the state or one of its agencies or officials to take a particular action, it is precluded from doing so.[3]

This basic principle is at odds with the attitude of many that serve within the regulatory process. Often, the attitude toward a company's proposed action is: "Where is the authorization in the insurance code for them to do that?" Commissioner Olson's response was "Where does the code prohibit the proposed action?" During his two years in office, Olson's consistent adherence to the principle that an individual is free to act unless specifically prohibited by law helped change the attitude of the bureaucracy. Olson appointed a deputy commissioner who agreed with this principle, and he worked to influence the thinking of many of the civil service staff.

*With rent-seeking costs reduced, the efficiency of Michigan's insurance markets increased.*

One way to measure the degree to which Commissioner Olson's outlook influenced the attitude of Michigan's regulatory bureaucracy is not in the most visible form — legislative action — but rather in another form — the levels of new and expanded regulation that did not occur during Olson's tenure. Instead of reacting defensively to state government attempts to use the regulatory process to enact policies that restrict consumer choice and redistribute income, insurance companies were able to act freely without the threat of additional regulation. With rent-seeking costs reduced, the efficiency of Michigan's insurance markets increased. To the extent that Olson did indeed convince the career staff of the insurance bureaucracy to change its thinking, the results will last well beyond his relatively limited term in office.

## LEGISLATIVE ACTION: THE CASE OF THE ESSENTIAL INSURANCE ACT

Once government interferes in a market, it will find itself forced to expand this interference. The portion of Michigan's Insurance Code known as The Essential Insurance Act (EIA) provides a good example of this. When the state interfered in the market for insurance, it reduced the availability of insurance for those in urban areas. Further rounds of state interference in the market did not solve the problem. Finally, under Insurance Commissioner Olson, legislation was passed that eliminated the most drastic part of

[3] Personal correspondence, July 31, 1997.

the government intervention and moved the industry toward a market solution.

In 1969, the state created the Michigan Automobile Insurance Placement Facility (MAIPF), which was required to provide insurance for anyone who sought it. The MAIPF was an assigned risk plan that did not allow for a choice of insurers, had limited coverage, and set high rates. Drivers who were unable to find a traditional insurer at affordable rates ended up in the MAIPF.

In 1972, the state made automobile insurance mandatory, beginning January 1, 1973. This requirement created a situation where many people in urban areas were forced to purchase automobile insurance even though the cost of premiums was high relative to their income. Premiums were higher in urban areas because insurance risks there were substantially higher than in other areas. Those forced into the MAIPF were dissatisfied with the high premiums and lack of consumer choice that it provided.

In 1978, the Michigan Supreme Court ruled in *Shavers v. Attorney General*[4] that the rate setting procedures in the state's insurance code were unconstitutional. The court concluded that the code's language that "rates shall not be excessive, inadequate, or unfairly discriminatory" was too broad and that drivers did not have sufficient ability to challenge rates, denial of coverage, or assignment to the MAIPF.

The Michigan legislature responded in 1979 with a new round of regulation by enacting the Essential Insurance Act.[5] This Act set limits on rate setting (as set out below) and the ability of companies to reject applicants. In addition to altering the MAIPF, it created a new residual market for homeowners insurance, as well as further regulations on the sale of homeowners insurance.

One of the most controversial aspects of the Essential Insurance Act was its territorial rating provisions. Under EIA:

(1) An insurer could have no more than 20 different territorial base rates per coverage;

(2) An insurer's lowest territory base rate could be no less than 45 percent of its highest base rate; and

(3) For adjacent territories, the rate in the lower rated territory could be no less than 90 percent of the higher rate. Actual losses in the area could not be used to overcome these restrictions.

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[4] 402 Mich. 554.
[5] Public Act 145 of 1979.

These restrictions prompted insurance companies to adopt a new strategy for writing policies. An insurer could either have rates high enough to cover its losses in the urban area and rates that were high relative to its competitors in the suburban areas, or it could set its rates to be competitive in the suburban areas and hope not to sell much insurance in the urban areas. A two-tier strategy resulted, with most insurers opting for the latter. By 1985, four companies issued more than 90 percent of the policies in Detroit.[6]

By 1986, the legislature was aware that the market had responsed to its legislation by creating the threat of insolvency for urban insurers and a lack of competition for the urban market. The legislature then stepped into the market in a different fashion. Public Act 10 of 1986 eliminated the territorial constraints and allowed an adjustment period for insurers to raise their urban rates. Then, no rates in urban areas were to be increased more than 4 percent plus the increase in the Detroit consumer price index in any 12-month period, or Detroit rates could be increased by the same amount as the insurer's rates in non-urban areas. This price-control experiment was to last five years, with the 1986 amendments expiring on July 1, 1991. Twice the date was extended, but another attempt to further extend the date and impose mandatory price reductions was vetoed by Governor Engler in April of 1993. Then law reverted back to territorial rating restrictions.

Finally, in February of 1996, Public Act 98 removed the territorial rate limitations altogether. Commissioner Olson's official analysis of that bill concluded:

> The removal of territory rating constraints can allow companies to price insurance coverage in a manner that truly reflects the cost of paying claims in an area. Such a system encourages insureds to engage in activities which contribute to the reduction of losses, the benefit being reduced premiums. Moreover, allowing companies to develop rates on a cost basis without constraints can result in more companies doing business in areas of the state where it may previously have not been cost effective for them to do so. The competitive effect of an increased presence of insurers and of insurance products in such areas can only benefit insurance customers who shop around for coverage.
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> The elimination of the rating constraints may result in a change in premiums, with some insureds paying more and some paying less, and some may argue that the removal of territory rate constraints will increase premiums in high loss cost areas and widen the disparity in

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[6] See *Michigan Insurance Handbook*, 1993-94, Lansing, Michigan: Public Sector Consultants, p. 84

premium differences between urban and non-urban areas of the state. From my viewpoint, however, it is more likely that insurers will be encouraged to expand their writings if they can base their rates on actual costs, resulting in increased availability in areas of the state where the positive effects of competition on rate level increases are currently weak.[7]

Olson's analysis certainly reflects a change in attitude towards the relative roles of government and private markets in setting insurance rates. It recognizes that attempts to fix prices will always result in shortages and lessened competition. The more complicated the price-control scheme, the more complicated the problem which it creates. His analysis is grounded in the knowledge that markets will allocate resources more efficiently than the legislature will.

*It is more likely that insurers will be encouraged to expand their writings if they can base their rates on actual costs.*

## THE LEGISLATIVE AGENDA

During Commissioner Olson's term, the Insurance Bureau helped support and advance a number of other legislative measures that were eventually enacted into law. Laws enacted during the 1995-96 legislative session include:

- Public Act 215, which provided for streamlining demutualization for Michigan insurance companies;
- PA 222, which revised the threshold for suing for non-economic damages for pain and suffering;
- PA 276, which made it easier for private firms to report fraud;
- PA 429, which provided for the priority of distribution of claims for an insurer in liquidation;
- PA 385, which established the interstate receivership compact;
- PA 314, which allowed the insurance commissioner to issue cease and desist orders; and
- PA 548, which provided general amendments to the requirements for bonds for surplus lines and life insurers selling legal expense insurance to promote competition in these markets.

[7] Memorandum from D. Joseph Olson, Insurance Commissioner to Jeff McAlvey, Director of Legislative Affairs for Governor John Engler, February 14, 1996.

Of all these bills supported by the insurance bureau, the two most important ones were PA 222 and PA 429. PA 222, by helping to limit potential losses due to claims for non-economic damages, resulted in lower premiums for all auto-owners. PA 429 solved some of the problems created by federal court decisions and avoided having the federal government's tax claim be the number one priority claim in an insurance company liquidation. Before PA 429, the courts had ruled that the state did have the right to set priorities for expense of administration and claims of policy holders under McCarran-Ferguson. However, if the state placed other claims above federal taxes, then the liquidation statute did not deal enough with the business of insurance to fall under McCarran-Ferguson protection. This ruling would have effectively let federal law take precedent over state insurance regulation. PA 429 altered the state's liquidation statute by placing the federal tax liability third — behind the insurance administration and policy holder claims — and thus preserving state control over this portion of insurance regulation.

*The attitude of seeing insurance companies in Michigan as a tool for enacting social change and a source of revenue for the government has given way to an understanding of the role of insurance in a market economy.*

Several bills that would have increased regulation of the insurance industry never became law, often at least partially due to Insurance Bureau objections. Only two bills of note did become law over the objection of the commissioner, and both bills were given a positive analysis by the Bureau in their original form. However, opposition to the original bills developed as they moved through the legislative process and substitutes were introduced.

## TAXATION OF INSURANCE IN MICHIGAN: CHANGE IN ATTITUDE

Under the administration of Governor James Blanchard, the insurance industry was seen as a source of additional state revenue. In a major legislative battle in 1986 and 1987, Governor Blanchard proposed levying a two-percent premiums tax on all casualty insurers and a three-percent tax on all property insurers in Michigan, which would have increased total taxes on insurance companies in the state by $80 million annually. Then-Senate Majority Leader John Engler responded by pushing through legislation that brought all insurance companies, both domestic and foreign, under the state's value added tax — the Single Business Tax. Although as part of the compromise there was an increase in taxes for insurance companies, the increase was less than half of that proposed by Governor Blanchard.[8]

People often judge administrations and legislatures based on the programs they enact. However, it is just as likely that they may have served the people well by simply not doing those things which others would have done.

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[8] For a detailed discussion of this episode, see Gary Wolfram, "Taxation of Insurance Companies in Michigan: Court Cases and the Legislative Debate," *Detroit College of Law Review*, Spring 1988, pp. 51-63.

After Mr. Engler assumed the governorship in January of 1991, his administration never suggested increasing taxes on insurance companies. In fact, because insurance companies are all taxed under the Single Business Tax (SBT), they actually received a tax reduction when Public Act 247 reduced the SBT rate in 1994.

The old attitude that viewed insurance companies in Michigan as tools for enacting social change and sources of revenue for the government has given way to a better understanding of the role of insurance in a market economy. The Engler administration realizes that markets function more efficiently with a strong insurance system. Private insurance allows the most efficient allocation of risk across individuals, and it creates a specialization of labor whereby some individuals take on certain types of risks and entrepreneurs take on others.

*Olson withdrew 45 existing bulletins that were adding to the regulatory burden of the insurance industry with little or no benefit to the consumer.*

## FORMS AND FILINGS — THE MARKET OR GOVERNMENT AS OVERSEER

As long as one assumes that government should and must regulate the buying and selling of insurance, government necessarily will need to have information about the industry. The more government chooses to interfere in the insurance market, the more information it must have. This leads to the need for insurance regulators to generate forms and the requirement that insurance companies and their agents fill out these forms. As government becomes more involved in the industry, government bureaucrats discover more aspects of the industry about which they must have information. Consumers and businesses then respond to the increased regulation, which creates new situations not anticipated by government and results in further intrusion into the actions of firms and their customers.

The change in attitude of the Engler administration was reflected in its policy towards rate and form filings. In 1994, Commissioner David Dykhouse substantially reduced the amount of paperwork burden imposed on insurance companies by issuing two bulletins. Bulletin 94-4 eliminated, with the exception of workers' compensation insurance, the requirement for insurers to report data on the loss and nationwide expense experience to the Commissioner or to any rating organization. Then Bulletin 94-5 determined that the filing of a good amount of supporting information for commercial insurance lines was not necessary, or desirable.

This movement away from government intrusion into the industry became more pronounced under Commissioner Olson. In 1996, he undertook a review of the filing manual which had been put together under the Blanchard administration, and a substantial number of modifications were made to remove requirements that were not necessary or not fully supported by statute, including the removal of an entire chapter governing claims made policy filings.

Commissioner Olson also recommended to the Joint Committee on Administrative Rules the elimination of more than 50 existing rules. These ran the gamut from requirements for insurance instructors to insider trading of equity securities. As commissioner, Olson withdrew 45 existing bulletins that were adding to the regulatory burden of the insurance industry with little or no benefit to the consumer.

In some areas, Olson reduced the regulatory burden through his own action. For example, Bulletin 96-03 enables insurers to seek relief from submitting securities to the NAIC Securities Valuation Office for valuation. In other areas, Olson lobbied successfully for legislation that strengthened the market process, such as Public Act 541 of 1996, which gives insurers broader latitude to establish new and innovative premium discounts without incurring the costs and delays of a hearing process as provided in the Essential Insurance Act.

*Olson proposed additional rules which would prevent the application of a "disparate impact" analysis to insurance market discrimination in Michigan.*

During the 1995-96 legislative session, Commissioner Olson proposed legislation to reduce greatly the volume of rate and form filings which insurance companies are required to submit under the Michigan Insurance Code. When the legislature failed to act on his recommendations, the Commissioner issued Bulletin 97-03 in January of 1997. This bulletin eliminated the filing requirements for a substantial number of forms. Except for a select few, all forms that had filing requirements under four separate sections of the insurance code were no longer required to be filed with the insurance bureau.

Commissioner Olson used his statutory authority to eliminate form filing and approval requirements where those requirements are found to be impractical or unnecessary for the protection of the public order. Along this same theme of consumers being intelligent enough to make their own decisions, Olson rescinded a rule that required prior approval of the commissioner in order to advertise for life and health insurance, as well as another rule that required disclosure in an ad where a celebrity was paid for a testimonial. Commissioner Olson believed that the general public is sophisticated enough to know that Michael Jordan endorses a particular brand of athletic shoes partly because he gets paid to do so.

## PROPOSED RULES TO HEAD OFF FURTHER REGULATION

At the end of his tenure, Commissioner Olson proposed additional rules which would prevent the application of a "disparate impact" analysis to insurance market discrimination in Michigan. That approach already had been endorsed by the U.S. Department of Housing and Urban Development

(HUD) and the Justice Department on the federal level, with respect to homeowners. The disparate impact approach essentially would force insurance companies to sell policies at below-market prices if the effect of using underwriting techniques has a "disparate impact" on privileged groups. This standard would apply even if the underwriting guidelines themselves are not discriminatory. Adoption of this principle in Michigan would result in reduced insurance services - particularly in high-risk areas—and higher insurance premiums throughout the state.[9]

In *NAACP v. American Family Mutual Insurance Company,*[10] the U.S. Court of Appeals for the 7th Circuit held that the Fair Housing Act (FHA) and, in particular, HUD's promulgated rule under the Act that prohibited the use of ratings for housing insurance that had a disparate impact on certain groups were not in conflict with the McCarran-Ferguson Act of 1945 unless the FHA and the state law were in conflict. The court reasoned that because Wisconsin did not have a statute or regulation allowing the practice of using a rating system which had a disparate impact, the federal law could regulate the state's insurance practices.

*The true purpose of such legislation was to limit the number of insurance agents.*

Commissioner Olson recognized the threat to state authority over the insurance industry imposed by the court's ruling, and he used the court's reasoning to protect the fifty-year tradition of McCarran-Ferguson. He proposed rules, submitted in July of 1997, that would provide that disparate impact is permissible in Michigan so long as the insurer's underwriting criteria, rating factors, or business practices are not based upon discriminatory criteria. The rules would also preclude HUD from imposing its enforcement agenda on Michigan insurers. Adoption of Olson's proposal would help maintain the regulation of insurance at the state level, but more importantly, it would ensure that companies continue to provide insurance services in high-risk areas.[11] These rules have not been acted upon as yet.

## REGULATION OF INSURANCE AGENT EDUCATION AS RENT SEEKING

One bulletin issued by Commissioner Olson illustrates his view that government regulation is often the result of special interest group domination of the political process in order to prevent entry into the market. Public Act 1 of 1992 created a mandatory education program for insurance agents. Under that law, agents are required to complete 30 hours of continuing

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[9] See Gary Wolfram, "Insurance 'Redlining' and Government Intervention," *The Freeman*, Vol. 47, No 6 (June 1977), pp. 365-369, for a discussion of the effects of this type of regulatory action.
[10] 978 F.2nd 287 (7th Cir. 1992)
[11] For a fuller discussion of this, see D. Joseph Olson, "State Commissioners Can Stop Federal Insurance Regulation," *Legal Backgrounder*, Vol. 12, No. 47, (Washington Legal Foundation, 1997).

education classes or home study every two years. One rationale offered for the legislation was, of course, that uneducated agents would mislead consumers if the government did not require these agents to attend a government-approved course of further instruction. The Commissioner correctly observed that the true purpose of such legislation was to limit the number of insurance agents. He noted that, under market competition, uninformed agents lose customers to those that are well informed and eventually move out of the business. There is no reason to believe that thirty hours of mandatory continuing education provide a value to consumers equal to or greater than the resources used up in obtaining such education (including the opportunity cost of the agent's time).

In December of 1996, Commissioner Olson used his statutory authority to "waive the continuing education requirements of this section for an agent if the commissioner determines that enforcement of the requirements would cause a severe hardship" and granted a waiver of the requirement for all agents for whom the costs of the program exceed the benefits it provides.[12] His action made the continuing education program a voluntary program for those agents who wish to pursue it. The individual agent could determine whether his customers and potential customers would value the continuing education sufficiently to reward the agent for undertaking the education.

*Olson's position that market allocation of resources is both efficient and crucial to individual liberty has oftentimes been at odds with the general philosophy of the NAIC.*

The Insurance Bureau held a public hearing in Lansing on October 28, 1996. It determined that the costs of the program, including the time cost of the agents, were over $16 million a year. No empirical evidence was offered of the value of the courses, but there was evidence that thousands of marginal and part-time agents had let their licenses expire due to the cost of complying with the rule. The Insurance Bureau found that serious agent misconduct remained at the same level despite the substantially fewer number of agents after the effective date of the Act (January 1, 1993). These numbers indicate that the Act has primarily served to restrict the number of agents in the market.

Commissioner Olson used previous examples of limited waivers of lines of insurance, granted by the two prior insurance commissioners in the Engler administration, as precedent to approve the broad waiver of the continuing education requirement.[13] The order was a clear statement by the Commissioner that the market can best determine the number of agents and the type of education and skills each individual agent should have. Unfortunately, the Ingham County Circuit Court overturned Olson's order. This decision was

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[12] MCL 500.1204c(11).

[13] Because most other states that have continuing education requirement for agents that wish to sell insurance in their state usually allow this requirement to be satisfied by meeting the requirements in the agent's home state, the Commissioner's ruling left in place a program of continuing education for agents that have nonresident agent licenses in states that impose continuing education requirements.

appealed, but the Attorney General dismissed the appeal after Olson left office. Even so, the direction of the debate has certainly changed. Rather than relying on burdensome regulation to preclude entry, incumbent insurance agents now must fight to preserve their current protected status.

## GUIDELINES AND MEMOS: COPYING OF RATE AND FORM FILINGS

*The true purpose of such legislation was to limit the number of insurance agents.*

When companies are required to file forms and information with the government, the information can be obtained by competitors. During the battle with the legislature over reducing the number of filings that had to be made with the Insurance Bureau, which culminated in bulletin 97-03, Olson and his staff became interested in the constant copying of rate and form filings by competitors. Using an insightful line of legal research, Commissioner Olson found that, since 1989, all of the filings have been protected by copyright, and such copying was in violation of the rights of the owners. Olson then sent out a bulletin stating that he would no longer allow such copying. This generated a firestorm in the legislature, in the industry, and among so-called consumer advocates. A request was made for a formal Attorney General's opinion on the issue. Olson followed with a request himself for such an opinion, with a series of questions demonstrating that the insurance commissioner cannot be a source of industrial espionage.

Unfortunately, the Attorney General responded to a different request for opinion on the same issue by Senator Christopher Dingell, finding in January 1998 that the commissioner must turn over copyrighted materials requested under the state's Freedom of Information Act.[14] This opinion did limit itself to ratings manuals, but the analysis would apply to all documents in question. The opinion seems to be less legal than political. For instance, the primary case cited, *Weisberg v United States*,[15] did not express an opinion on FOIA versus copyright laws. It merely held that the copyrighted subject photographs were "agency records," and it sent the case back to district court to seek joinder of TIME and to decide what to do if that could not be accomplished. In addition, in the case of Michigan, a federal law (copyright) and a state law (FOIA) are in conflict. The supremacy clause of the U.S. Constitution reconciles in favor of federal law. Nonetheless, the Attorney General's opinion is binding on the bureau until overturned in litigation.

[14] Attorney General Opinion No. 6965.
[15] 631 F.2d 824 (1980)

## NAIC AND TRADE RESTRAINT: THE CASE OF SVO AND MODEL INVESTMENT LAW

Commissioner Olson's position that market allocation of resources is both efficient and crucial to individual liberty has oftentimes been at odds with the general philosophy of the National Association of Insurance Commissioners (NAIC). The NAIC is made up of 55 state and territorial insurance commissioners. It employs more than 300 people in its offices in Kansas City, New York, and Washington, D.C. As might be expected from an organization of regulators, the consensus among this group is that regulation is just, proper, and necessary. This is not to say that pure self-interest motivates their opinion, but generally people who want to be in a regulatory position will believe in regulation.

*The Michigan approach, would prevent the NAIC's codification project from reducing the discretion of state commissioners to allow companies a choice of investment portfolio in accordance with local conditions.*

An individual commissioner, working with a staff of civil service employees likely to generally believe that regulation is something to be sought after and upheld, is in a difficult position when trying to go against the tide of the NAIC. Commissioner Olson's trials in dealing with the NAIC are best described through two issues: the model investment statute and a requirement that insurers have their securities rated and valued by the Securities Valuation Office of the NAIC — for a fee.

The model investment law is an esoteric part of public policy of which most people who simply pay their insurance premiums are completely unaware. However, NAIC passage of a model investment law sets a standard by which examiners in other states may begin to challenge the portfolios of Michigan domestic companies. Previous Engler appointees recognized this problem, but their attempts to get the NAIC to adopt a "prudent person"[16] standard rather than the regulated model statute failed.

With the influx of new insurance commissioners in 1995, Commissioner Olson saw an opportunity to urge the NAIC to adopt this much less invasive standard. A working group put together in 1996 submitted a prudent person model to the NAIC executive committee in December of 1996. Unfortunately, the executive committee voted down the proposal because states that had adopted a more regulated investment portfolio model did not want prudent person states to have the freedom to operate under that regime. The model was returned to the task force and revised to be quite similar to the existing model, conforming to the premise that government regulators know more about how to invest an insurance company's money than the company does.

Of particular concern was an NAIC project to develop a uniform system of accounting to be imposed on all states for the purposes of statutorily

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[16] The concept would be that a company could invest in securities that a prudent person would invest in, disallowing overly risky investing but allowing flexibility.

required audits, even states that had not adopted the NAIC standard. In this way, the NAIC could extend its regulatory philosophy throughout the country. When Michigan-certified public accountants obtained enough legislative consensus to rewrite their licensing law, Commissioner Olson spotted an opportunity. He worked to obtain passage of a Senate amendment preserving the right of Michigan insurers to an audit based upon Michigan law, by adding language saying that audits of Michigan insurers are to be based upon accounting principles as prescribed or permitted by the insurance code. This success was, of course, met with much recrimination by the insurance companies committee of the American Institute for Certified Public Accountants and the chief examiner serving on the codification of statutory accounting working group at the NAIC. However, if more states were to adopt the Michigan approach, they would prevent the NAIC's codification project from reducing the discretion of state commissioners to allow companies a choice of investment portfolio in accordance with local conditions.

Another example of Commissioner Olson's battle with the national regulatory apparatus involved the Securities Valuation Office (SVO) of the NAIC. Michigan companies were required to have their securities rated and valued by the SVO, even if these securities were already rated by another agency. Because Michigan's insurance companies were subject to inordinate fees to obtain the SVO statement, Commissioner Olson set forth a procedure in the December 1996 annual statement instructions under which the commissioner could waive requirements that securities be submitted to the SVO. Basically, it provided that if the insurance company has a reasonable method for valuing the security (e.g., if it is rated by a nationally recognized statistical rating organization), and the cost of submitting the security to the SVO in relation to the value of the security is a financial burden, then the commissioner can waive the requirement for SVO rating.

Olson's initiative in this area led to a heated discussion at the NAIC meeting in March 1997. The Illinois insurance commissioner sent a letter to Commissioner Olson announcing that Michigan companies that wanted to do business in Illinois would be required to use the SVO rating. Nonetheless, Commissioner Olson was undaunted, and Michigan has thus far withstood pressure to conform to the NAIC requirement.

Commissioner Olson's experiences with the NAIC indicate the mischief that a national association of regulators can make by imposing its regulations throughout the nation with the use of model statutes and lobbying of state legislatures. In general, a legislator is likely to take a model statute that has been prepared by "experts" and adopt it. Since insurance codes are complex (one might say needlessly so), the average legislator has a strong incentive to adopt a code already adopted in other states and approved by an association of regulators, rather than take the responsibility of standing by the market process. There is little political cover in the latter and much in the former.

Using model regulatory statutes is one way for regulators to escape the classic prisoners' dilemma.[17] A state reaps economic advantages by having a number of domestic insurance companies. A regulatory environment that allows that company flexibility to compete in the market place will attract insurance companies to establish their domiciles in a state. Thus each regulator is faced with a dilemma: he or she would like to have as much regulatory power as possible, but relaxing this regulatory power can give them more companies to control.

The NAIC and its model statutes are the enforcing mechanisms that move the regulators to a cooperative strategy in the game theory sense. As the accounting example shows, even in states where the NAIC can't get its model statute passed, it still may get the auditing procedure to require that companies follow the NAIC standard. Because companies often do business across state lines, a coordinated effort by regulators in a majority of the states can enforce regulations on states that wish to "cheat" in the prisoners dilemma parlance and undertake a market-oriented approach.

*Concerns over the NAIC's centrally planned regulatory approach did not disappear with Olson's departure.*

Concerns over the NAIC's centrally planned regulatory approach did not disappear with Olson's departure. In December of 1997, the Michigan Senate adopted unanimously Senate Resolution 113, which expressed the Senate's unhappiness with attempts by the NAIC to impose national regulatory standards on Michigan. In addition to the resolution, state senator Michael Bouchard, chairman of the Senate Committee on Financial Services, introduced Senate Bill 723, which would impose reciprocal penalties on foreign insurers if Michigan companies were penalized in the foreign companies' state for failure to comply with NAIC standards. SB 723 was substituted into House Bill 5418 and passed the Senate.

The Michigan Senate's actions are one more indication that the tone of debate in Michigan has changed from assuming that insurance markets are best operated under the control of a central bureaucracy to realizing that markets are the most efficient mechanism for allocating resources. Once the debate centers on the issue of planning versus markets, it builds momentum to go beyond the tenure of those leaders who originally addressed the issue.

## CONSUMER CHOICE

Governor Engler offered a legislative proposal suggested by Commissioner Olson that would increase the amount of consumer choice allowed

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[17] For a discussion of the prisoners' dilemma, see Avinash Dixit and Barry Nalebuff, *Thinking Strategically: The Competitive Edge in Business, Politics, and Everyday Life*, (New York: W.W. Norton, 1991), Chapter 4.

under the insurance code. Current law is based upon the premise that consumers will not choose the correct type and amount of coverage if left to their own devices. The government, as central planner, thus limits the types of policies that are available. Governor Engler's administration has made progress in replacing this position with one that views consumers as capable of determining their optimal amount of insurance.

This latest proposal is called the "Driver Savings and Lawsuit Protection Plan." Under the plan, consumers are able to choose insurance coverage that allows them to keep their current personal injury and property protection for economic damages while not purchasing insurance for non-economic damages. Someone choosing this coverage could neither sue nor be sued for non-economic damages such as pain and suffering. The Insurance Bureau estimates that this would result in premium reductions of more than $100 annually for consumers that made this choice. Consumers still could buy optional insurance providing pain and suffering damages from their own insurance company, thus avoiding the need to hire a lawyer and sue to collect.

*The strength of Michigan's insurance market consistent with a beneficial effect of the Engler administration's attitude of allowing the market to determine the allocation of resources.*

This proposal is an extension of another system advanced by Jeffrey O'Connell of the University of Virginia Law School and Michael Horowitz of the Hudson Institute, known as "Auto-Choice." That plan was laid out in a recent report by the Joint Economic Committee.[18] The primary difference between the two plans is that Michigan is currently under a no-fault system. Consumers choosing Olson's plan would eliminate virtually all tort actions arising out of automobile accidents. Claims for non-economic damages would be recovered from one's own insurance company. The underlying premise of these plans is that consumers are capable of deciding how much and what type of insurance to buy, and that such consumer choices result in more efficient use of resources than government-mandated insurance policies. The estimate of premium savings does not reflect the additional advantages of a more efficient distribution of risk under the broadened choices available.

The Olson proposal, espoused in the media by Governor Engler, has not yet been drafted into legislation, and it awaits action in future legislative sessions.

## THE CONDITION OF MICHIGAN'S INSURANCE MARKET

Due to the number of variables that influence the strength of any industry, it is difficult to conclude that any one particular policy is responsible

[18] Daniel Miller and Joseph Englehard, "The Benefits and Savings of Auto-Choice," Joint Economic Committee of the United States Congress Report, April 1997.

for improvement or deterioration. The insurance industry, in particular, suffers from what is commonly known as the "underwriting cycle," during which years of higher than anticipated losses are followed by increased premiums and increased profitability. Increased profits lead to rate reductions as insurers attempt to expand their market. The next cycle begins with an increased loss ratio, which lead to another period of reduced amounts of insurance and increased premiums.

Despite the inability to be conclusive about the effect of the Engler administration on insurance markets in Michigan, it is interesting to look at some of the data.

## Table 1

| Year | Total Number of Companies | Total Number of Companies Based in Michigan | Total Direct Premiums |
|---|---|---|---|
| 1990 | 1519 | 105 | $19.322 |
| 1991 | 1677 | 169 | $25.913 |
| 1992 | 1684 | 172 | $26.429 |
| 1993 | 1581 | 166 | $28.750 |
| 1994 | 1505 | 164 | $32.068 |
| 1995 | 1514 | 165 | $33.758 |

Source: State of Michigan, Michigan Insurance Bureau

The number of companies has fluctuated substantially, with a large increase in 1991 and a substantial drop off in both 1994 and 1995. The number of Michigan companies, however, has maintained the large jump that occurred in 1991, the first year of the Engler administration. Total direct premiums have risen steadily, increasing by about 3/4 since 1990.

The strength of Michigan's insurance market as reflected in the data is at least consistent with a beneficial effect of the Engler administration's attitude of allowing the market to determine the allocation of resources. The data also reflect feedback on the insurance industry from the improved state economic climate that has been the result of a lowered tax burden and less regulation in general under Governor Engler.[19]

*Such consumer choices will result in a more efficient use of resources than a government-mandated insurance policy.*

[19] For example, Michigan's unemployment rate has not been above the national rate since June of 1992, after being above the national rate in every month prior to that since March of 1978.

## CONCLUSION

The Engler administration has gone against the grain in its approach to government regulation. It has recognized that central planning cannot solve the problem that information is decentralized and government bureaucrats cannot efficiently manage a modern economy. The appointment of Joe Olson to the post of Commissioner of Insurance was a clear indication of the Engler position. As Commissioner, Mr. Olson was able to change the terms of the debate and the attitude of many of the bureaucrats in his department. He started with the basic premise that individuals have the right to their property and that governments need and should only act in the face of clear market failure. His record was one of significant changes in the level of understanding of the nature of government regulation. He was successful in reducing the level of regulation of the insurance market in Michigan, through use of the rule-making power and some victories in the legislative arena. He also challenged the National Association of Insurance Commissioners in an attempt to allow states the ability to follow the path to market efficiency and consumer sovereignty.

Although this report has rightfully highlighted the term of Commissioner Olson, it is important to make the point that his tenure was part of a trend, beginning with the efforts of then-Senate Majority Leader Engler, extended by Commissioner Dykhouse under Governor Engler, and continuing beyond Commissioner Olson with the efforts being made currently in the Michigan Senate.

There are specific lessons to be garnered from the Michigan experience that can be carried into other states: Commissioner Olson's use of his authority to reduce the amount of filings that insurance companies must make, his clear articulation to the regulatory bureaucracy of his vision for the bureau, and his clever use of rule-making authority to overcome the intrusions of the NAIC and HUD. The primary lesson to be learned, however, is, in the words of Richard Weaver, that ideas have consequences. Michigan experience shows that if legislators and administrators have the courage of their conviction and can articulate the benefits of the market process over central planning, then the tide can be turned in favor of free market principles.

## ABOUT THE AUTHOR

Dr. Wolfram is George Munson Professor of Political Economy at Hillsdale College and President of Hillsdale Policy Group, a consulting firm specializing in taxation and policy analysis. He is a member of Michigan's State Board of Education, and has served as Chairman of the Headlee Amendment Blue Ribbon Commission and as a member of the Michigan Enterprise Zone Authority, the Michigan Strategic Fund Board, and the Michigan State Housing Development Authority Board. Dr. Wolfram's public policy experience includes serving as Congressman Nick Smith's Washington Office Chief of Staff, Michigan's Deputy State Treasurer for Taxation and Economic Policy under Governor John Engler, and Senior Economist to the Republican Senate in Michigan. Professor Wolfram graduated summa cum laude from the University of California at Santa Barbara. He received his Ph.D. in Economics from the University of California at Berkeley and has taught at several colleges and universities, including Mount Holyoke College, The University of Michigan, and Washington State University. His publications include *Towards a Free Society: An Introduction to Markets and the Political System*, and several works on Michigan's tax structure and other public policy issues.