barriers to private insurance

▲ *State not federal regulation.*

▲ *Tort nonsense.*

▲ *Free contracting.*

▲ *Restrictions on rates.*

▲ *...and innovation.*

The American insurance industry is shackled by regulations and restrictions on all sides. Fred Smith, of the Competitive Enterprise Institute, assesses the harm done. Could Britain follow?

Modern society has become increasingly safety conscious. Apparently, the desire for security is highly income elastic perhaps because wealthier people have more to lose and respond accordingly. But, for whatever reasons, we face growing pressures to reduce risks and to ensure that those harmed by misadventure receive compensation. The wisdom of this pressure is doubtful and in particular the rationality of targeting some risks over others can be called in question. Often specific risks are given priority over others seemingly of far larger size.

The growth of government safety programmes has been significant in recent years. Federal and state governments have become extensively involved in providing insurance both directly and indirectly. As measured by revenues collected ('Premiums'), government insurance equals or perhaps even exceeds private insurance. Regulation motivated by safety considerations has proliferated in recent decades including such major agencies as the Food and Drug Administration, the Environmental Protection Agency, and the Consumer Products Safety Commission. Finally the courts have come to play an important safety role – 'protecting' the individual from 'unconscionable' contracts and compensating 'victims' via a transformed tort law. A growing body of research suggests that these approaches are unlikely to improve safety. Too often government insurance neglects the important options of risk management and loss control; that neglect may actually reduce safety.

Government regulations have a predictable bias in favour of the status quo. New products are viewed as inherently more risky and are required to survive far more stringent safety tests. This bias delays the introduction of risk-reducing innovations and threatens to reduce safety overall. Overly conservative efforts to keep us safe from one type risk (the risk of introducing a dangerous product) can increase other risks (the risk that we forgo a safer technology) even more. Studies of some regulatory bodies (the Food and Drug Administration, for example) have demonstrated this effect – the safety losses resulting from the delays and rejections prompted by FDA rules have made us less safe!

Finally, the efforts of the courts to reduce risks are also questionable. The reduction of the right of free contract has limited innovation in risk management. If firms cannot assign risks via enforceable contracts, they will find it difficult to develop the specialised knowledge needed to assess risk adequately. Unless a risk reduction firm can shield its customers from its mistakes, it has little to sell. The parallel move to transform tort law from a system of corrective justice – an effort to identify and require restitution from alleged wrongdoers – to a system of victim compensation has created major difficulties for insurers while doing little to help most 'victims'.

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Why has there not been more involvement by the private sector in risk management? Several factors warrant consideration. First, some risks may be simply too large or the risks too imprecise for the private sector. But even here government action may be unwarranted; understanding of government failure remains limited. Moreover, even if the government fails, it may stop private insurance. The premiums charged by the government agencies may make it difficult or even

impossible for a private firm to compete.

Second, insurance is a heavily regulated industry and private insurance may be hindered by regulation. Regulation often restricts the ability of firms to respond to changing conditions and that might well account for the slow growth in private risk management. Another difficulty faced by private insurers is changing judicial policies over the last several decades. The rights of individuals to assign risks voluntarily via contract has been dramatically curtailed. Insurers find it difficult to design policies to control losses and encourage safety. Limiting the ability of individuals to agree in advance on what will be done in the event of an accident means that more weight is placed on resolving the inevitable conflict after the event. Generally, this means a much more contentious tort process.

Since many have come to view tort law as a system intended to guarantee compensation rather than determine fault, they have also weakened or eliminated many traditional tort defences. Worse, these changes are continuing to make it even more difficult for insurers to determine risk of a specific circumstance and to apply appropriate insurance rates.

Government is heavily involved in direct insurance. The power to tax and – at the federal level – to print money makes government insurance very attractive. In terms of liabilities, payments, and even receipts, insurance provided by the federal government already exceeds that provided privately. Programmes include social security to export guarantees, from flood and deposit insurance to riots and crops: all are insured by the federal government. The size of this activity is impressive. Mark Green in a 1975 article, 'The Government as an Insurer', noted:

> Not generally realised is how extensively the state and federal governments have become involved in the insurance business as an insurer, both directly and indirectly. Much more attention has been given to the role of government as a regulator. However, both federal and state governments have steadily enlarged the scope for their insurance operations until the point has been reached that nearly half of the total premiums collected in the US represent government plans of different kinds...If the trend continues, by about 1980, the federal government's share alone will exceed that of the private sector.

Green went on to quote George Bernstein, former director of the Federal Insurance Administration, who stated:

> And there is every indication that this involvement (the federal role in providing insurance) will grow, rather than diminish, in the years ahead unless fundamental marketing reforms are undertaken by the insurance industry itself.

But private insurers would not necessarily be welcomed by their government counterparts. Success by a private David against the government Goliath might well trigger charges of 'cream skimming'. They might well be accused of succeeding only by attracting the best customers and leaving to government the difficult cases. Nonetheless on occasion, private firms have challenged government in several insurance areas. Examples include mortgage insurance and – until the collapse of the Maryland and Ohio state-operated deposit insurance plans – deposit insurance.

‘overly conservative efforts to keep us safe from one risk can increase others’

There are several areas of risk in which, although the government does not sell insurance directly, it does specify in some detail the form that private insurance must take. An example is Workers Compensation Insurance. Under Workers Comp, the employee gives up his right to sue his employer in return for a guaranteed payment in the event of an accident at work. By federal law, most firms must have this type of insurance. This scheme might well have been the correct solution for the problems encountered by many firms and workers in the early part of this century. Unfortunately, the decision to legislate for the details of the original agreement weakened the ability of firms and their insurers to evolve new policies to meet changing conditions. As a result, the Worker's Compensation system has been seen as increasingly unfair. In response, courts have sometimes allowed victims to reach past the employer to the ultimate supplier of a device that might have been implicated in the accident. At the same time, courts have begun to question the immunity of the employer.

The extent to which government insurance is a significant effect in reducing the scope of the private sector is unclear. State insurance provides some element of risk reduction (largely by ensuring compensation in the event of misfortune) and thus reduces the demand for private insurance. Many, of course, would argue that the existence of the government insurance merely indicates the inability or the unwillingness of private firms to insure these risks. Private deposit insurance, for example, was presumed to be unavailable as was flood insurance. If true, then there is no effect. The question remains whether the lack of such insurance reflects the incompetence of industry, the superiority of the federal government, or the difficulties posed by other government insurance programmes.

Unlike transport or telecommunications, insurance in the United States is regulated predominantly at the state rather than federal level. This economic balkanisation of the insurance industry has its advantages – states vary widely in the way they regulate and this permits greater scope for innovation and competition. Nonetheless, regulation reduces the ability of firms to respond rapidly and creatively to changing market conditions. It is not easy for even the most efficient regulator to forge through the mass of data necessary to demonstrate the 'reasonableness' of a proposed change; nor is it easy even to assemble the data needed to initiate such changes. These problems are likely to be most severe in those periods when conditions are changing rapidly.

But regulations provide many opportunities for 'favour seeking' on the part of various interest groups. Currently established insurers might block new competitors by arguing that established 'capacity' is already adequate and that additional firms would merely lead to 'excessive' or 'cut throat' competition. Such strategies might restrict the more aggressive firms, exactly those firms most likely to take on the broader risk management roles in question. Also firms offering new risk management policies may require a broader base to spread the risk adequately and this may be limited by state regulation. (This problem has arisen in banking where farm and energy banks have been unable to diversify and thus to ride out local recessions.)

There are numerous ways in which the insurance industry is regulated. The following describe some of these and indicate how they might restrict the scope of the private sector.

- **Rate Regulation:** In some states, insurance rates are regulated for some classes of business: states differ as to whether the rates must be reviewed in advance of their promulgation (prior approval states) or whether some less intrusive form of regulation is pursued (competitive rating states). Rate regulation is most common in the health/life and personal property/casualty lines and seems to be less dominant in the latter. The evidence suggests that rate regulation cannot stop competition. Firms restricted from seeking additional customers based on price will engage in non-price competition. No improve-

CUTHBERT HEATH: INSURANCE GIANT

Cuthbert Heath (1859—1939) was one of the greatest innovators that the insurance industry has ever known. Heath, whose name survives in the firm C.E. Heath, was the inventor of several new forms of insurance. He worked in the open, unregulated markets of Victorian and Edwardian England; but how successful he would have been in the heavily regulated insurance markets of today is open to question.

Heath, who was an underwriter in the Lloyd's insurance market, invented both burglary insurance and loss of profit insurance as a result of fire. The story is told that Heath was sitting at his 'box' or trading desk at Lloyd's where he was in the process of accepting a fire risk when the broker asked, as a joke, whether the property could be insured against burglary — there having been a spate of burglaries in the home counties. Heath's legendary reply was; 'Why not?' and burglary insurance was born.

Cuthbert Heath also originated excess of loss reinsurance. Following the San Francisco fire in 1906, Heath had instructed his agents to pay claims without quibble, many American insurance companies suffered heavy losses. Heath suggested a form of reinsurance whereby small losses were paid by the insurance company, but large losses above a certain level were passed on to the reinsurer. Excess of loss reinsurance remains an important way in which insurance companies can 'lay off' their risks.

Cuthbert Heath was a dominating personality in the London insurance market and almost single handedly ensured that Lloyd's instituted an audit for its syndicates of insurers.

(Further Reading: Anthony Brown, *Cuthbert Heath*, David and Charles, 1980.)

ments in profitability may occur as the gains of higher prices (or the losses in quality) dissipate the initial gains.

- **Product Approval:** Some states restrict the ability of firms to market new insurance products. Such regulations may require that the firm submit data on the expected profitability of the new product. The regulator may approve the offering but regulate or freeze the projected rates. Such policies can discourage innovation as many useful products cost more than anticipated. If rates cannot be adjusted the innovator faces considerable risk and may elect to drop his innovation. Were such approval required elsewhere, say housing or appliances, there would be fewer new products. As a general rule, regulators require 'objective' data. They are required to ensure that rates are 'fair and reasonable' and this requires objective (i.e. numerical) data. Thus, insurance products are more likely to be offered in areas where data is more readily available; yet, it is exactly those less explored areas of risk management that we wish to pioneer. Regulation may thus inhibit most seriously the entrepreneurial forms of insurance that a society concerned with novel risks would most like to see flourish.
- **Entry/Exit Approval:** The insurance industry is more balkanised than other industries. There is no Alabama auto or California home appliance industry; insurance firms must be licensed to do business in each state separately. The terminology employed shows the importance of this restriction – firms headquartered within the state are referred to as 'domestic' firms, out-of-state firms are referred to as 'foreign' firms, while firms from outside the US are referred to as 'alien' firms. This diplomatic language is carried over into other aspects of the business – risk sharing arrangements between firms are referred to as 'treaties'.
- **Forms Approval:** An interesting form of regulation unique to the insurance industry is the forms approval. The forms used to specify insurance contracts must be approved by the states. This makes it more costly to modify contractual terms to meet changing economic conditions. One example has been the recent attempt by the insurance industry to shift its environmental policies to a claims made basis. That is, rather than insuring against any possible future claims, the insurance firm would simply protect against any claims made during the period in which the insurance policy was in effect. The cover offered by this type of policy is less than was offered by earlier policies and not surprisingly those now insured protested. They succeeded in slowing down and occasionally blocking the approval of such forms in several states.

There are a number of other ways in which current policies affect private risk management.

- **Antitrust Restraints:** Insurance prior to a decision by the Supreme Court in 1944 was exempt from the antitrust laws since it was deemed not to be 'interstate commerce'. That happy state was eliminated when a case brought before the Court, US vs. South-Eastern Underwriters Associations demolished that defence and brought insurance firms under the sway of federal antitrust regulations. Prior to that decision, insurance firms freely entered into joint data sharing agreements, and to better coordinate their pricing and customer selection policies. The decision threatened many existing practices and seemed likely to lead to major disruptions. Congress responded by enacting legislation in 1945, the McCarran-Ferguson Act, which restricted the scope of federal antitrust regulations. However, that Act should not be seen as deregulation but rather support for state over federal regulation. Under McCarran-Ferguson, states could elect to regulate insurance and by doing so, shield their firms from federal antitrust regulation. The effect of this was to encourage – indeed force – states to expand their regulatory control over the insurance industry. It is not clear that McCarran-Ferguson provided adequate freedom from federal antitrust regulations. Les Cheek, spokesman for the industry, has argued that the 'limited immunity' available under the McCarran-Ferguson Act disallowed exactly those acts which made it possible for the industry to impose checks on its customers. Cheek argued that such regulation was based on the ability of the

industry to refuse to deal with groups failing to observe safety practices or to raise in concert the rates charged such risky firms. Such agreements – construed as 'boycotts' and 'price fixing' under standard antitrust regulations – remain illegal under the limited protection of the McCarran-Ferguson Act. Eisenach reviewed the impact of the limited collective ratemaking permitted under McCarran-Ferguson. He asked first whether collective rate making even in the absence of state enforcement would raise prices above competitive levels. Secondly, he questioned whether collective rate making would reduce costs by allowing more efficient use of information (list pricing, it is argued, lowers the search cost of finding an acceptable product). He found no clear case for or against reducing the scope of the antitrust laws as the evidence showed that they had no effect.

- **Requirements Imposed on the Insurance Industry:** Other restrictions likely to impede the development of private insurance are rules that impose additional requirements on those firms wishing to sell insurance. These rules act as 'regulatory taxes' adding to the costs of doing business, for example, in car insurance, the requirement that a firm write a certain percentage of all 'assigned risks' or that the industry form a joint underwriting group to allocate such policies among themselves. These arrangements require the firm to insure individuals or firms not insurable under normal criteria or not insurable at rates believed 'fair and reasonable'. Such compulsory cover constitutes an indirect tax on the industry and may well encourage insurers to avoid risks where such assigned risk requirements might prove disastrous. For example, were a firm required to insure 'small hazardous waste facilities' as a cost of doing business, it might well elect not to offer any insurance in this field. Even when a state does not now impose such requirements, the fact that it might in the future could act as a deterrent to private insurers entering the market.
- **Anti-Discrimination Rules:** One of the newest restrictions on the insurance industry and again one that reduces the prospects for a broader role of private risk management is the growing tendency to make illegal the use of statistics that are deemed 'unfair'. Sex, age, race, even health tests in the case of AIDS – may be prohibited as ways of setting premiums. These restrictions vary widely by state and type of insurance.
- **Government Specification of Terms:** The government allows private firms to insure but legislatively defines tort liability so as to make it difficult to determine the expected losses. Superfund provides an ideal example of that type of situation. Superfund encouraged insurance firms to provide coverage to waste management firms, but then expanded the class of parties 'responsible' for hazardous waste clean-up costs so broadly as to include almost anyone. The doctrine of joint and several was misapplied to exacerbate this problem of definitions. The result is that almost anyone associated with any hazardous waste site can be held liable for the costs of clean-up and that fact makes it extremely difficult to define the risks that a firm may face and for the insurance industry to set its premium rates.
- **Financial Reserve Regulation:** Insurance firms are required to hold certain reserves to ensure that they will be able to pay off policy holders in the event of a disaster. These reserve requirements would be necessary in any case, but may be used to discourage entry and innovation. In the financial services industry, for example, reserve requirements become a major form of discipline to stop innovation. Firms find it difficult to develop new ways of providing liquidity, for example. The decision as to whether a given innovation improves or weakens the ability of the insurance firm to meet its obligations is extremely difficult to determine and the potential for mischief is large.
- **Tax Treatment of Insurance:** An

insurance company dealing in risks that extend over time (as opposed to say auto or home insurance that is restricted to the period of coverage) faces a complex accounting problem similar in nature to that involving depreciation of capital equipment. Some of the net earnings (premiums less management costs) represent the current value of future payments to policy holders and should not be viewed as profits. The rules used by Treasury to determine the allowable reserve are obviously subject to dispute. Treasury will allow only designated groups to use this deduction – thus, tax treatment limits the range of firms that can self-insure. The recent tax reform act modified the way in which Treasury is authorised to calculate these allowable reserves and may change the profitability of insuring risks extending into the future.

- **Refusal to Allow Certain Forms of Insurance:** In some states political considerations may make the insurance commissioners reluctant to approve a certain type of insurance. A firm, for example, may wish to insure itself against the economic losses associated with a strike. An insurance firm may be willing to write such insurance but be blocked by those seeing this as 'unconscionable' and antithetical to the 'public interest'.

Insurance is a business that involves future commitments based on current contracts. A firm will make a decision to insure or not based on a number of factors including how they believe the court will interpret this contract language and how it will determine responsibility in the event of an accident. Over the last several decades, contract law has changed, as has tort law. The effect of these changes has been to reduce the predictability of the risk markets and thus to reduce the scope for private insurance.

In the court system, there has been a continued move to restrict the rights of individuals to manage risks. The logic of that restriction grows out of the belief that the individual in the modern world lacks power and knowledge and is at the mercy of the powerful special interests. This concept has led the courts to reject many contracts as 'unconscionable' and as 'contracts of adhesion'. The effect has been to create unnecessary disputes and to convert normal contract disagreements into tort suits.

This restriction is unfortunate; contracts are voluntary exchanges. They permit both parties to make agreements that each views as favourable. Contracts can and should include the possibility of misadventure and specify what is to be done in such cases. Prior contracting minimizes the difficult question of the values placed by the respective parties on losses. Before the event, the two parties are dealing in a positive sum world in which there are benefits and costs, and both parties have every reason to weigh carefully their choices. Once an accident has occurred, there is no reason for either side to treat the issue in this balanced way. In the aftermath of disaster, the parties operate in a zero sum world in which what one gains the other loses. Neither honesty nor objectivity are encouraged.

There will, of course, be situations in which prior contracting would be impossible. Situations will occur in which strangers harm one another. In other cases, voluntary arrangements might have been possible but for one reason or another will not have been arranged in advance. In either case, the fact remains that neither party to such a dispute can be expected to volunteer accurate information on their valuations of the losses involved. Thus, we must designate an 'objective' third party to take on the thankless task of assessing the facts and evaluating the size of the losses.

Voluntary arrangements should be encouraged wherever possible. That has not been the course followed. The right of contract has been reduced, increasing the burden on the tort system. Much of the 'crisis in the tort system' results from this misclassification problem. Medical malpractice, conflicts between customers and service groups, and product liability might all be better handled by prior agreement. Competition would encourage a range of agreements where such flexibility was both possible and valued. The wider reliance on contracts would simplify the task of the tort system. For example, a person who accidentally wandered onto a playground and injured himself would be treated just as one of the various types of customers of the playground. Without this method of resolving disputes we find ourselves, like the socialist planner, trying to determine the appropriate price of goods in an unpriced environment.

A second aspect of this limit on contracting is the tendency by at least some courts to reinterpret the terms of the contract in ways that appear contrary to the original intent and understanding of the parties. Of course, the courts have always construed ambiguous terms in favour of that party likely to have the least knowledge of the problem. But some courts seem to have gone far beyond that valid rule. The widely publicised Jackson Township case in New Jersey where a policy against 'sudden and accidental' pollution was construed as covering a pollution problem that emerged over a long period of time is a classic example.

Tort issues provide the most complex element of the overall insurance issue. Torts require the courts to assess the relative values placed on specific injuries by others. That task is relatively arbitrary but unavoidable. Insurance companies would be expected to track court opinions on such subjective valuations and adjust their premiums accordingly. But that process has been made less predictable because the insurance firm must not only track trends in this subjective valuation process but also follow trends in the way in which courts determine guilt. In earlier days, the tort system was viewed as providing the right of an injured party to seek restitution against the alleged wrongdoer (or tortfeasor). This process required that the injury be demonstrated and that the defendant be shown to have 'caused' the injury.

This view of the tort system has largely been replaced by a vision of torts as a means to ensure that 'victims' are compensated. This view conveys special status upon those suffering harm. To attain 'compensation', courts have stretched the concepts of responsibility very broadly, and have created concepts of joint and several liability that make it possible to convict parties having only a weak link to the event in question. They have also reduced the requirements for demonstrating causality.

Insurance companies face a situation where what decides whether their client is likely to incur financial liabilities has little to do with their client's participation in any particular activity. If such policies become the norm and consequently predictable, it may again become possible for insurance firms to offer policies. But insurers will be unlikely to devote much effort to research into the actual risks entailed if they have little relevance to the financial risks involved. Insurance would retain its risk spreading but abandon its risk management role.

'economic balkanisation of the insurance industry has its advantages'

Restrictions on insurers now greatly affect the way in which they do business. Perhaps, the most dramatic example of that fact is the growth in captive insurance companies over the last several decades. These firms are special firms created by companies to provide insurance in situations where conventional insurance is unavailable or where the rates or terms are viewed as unattractive. The growth of captives was explained as the result of firms trying to escape government restrictions. EA