2 – Insurance Regulation

**1 – Reasons for Insurance Regulation**

**Objective**: *Explain how insurance regulation protects consumers, contributes to maintaining insurer solvency, and assists in preventing destructive competition*

Regulation is necessary to correct market imperfections, whether those imperfections result from externalities, incomplete information, costs, or other causes. The reasons for regulation can differ; each market participant, each regulator, and each observer may offer different reasons for regulating a particular market.

The insurance industry is regulated primarily for three reasons:

* To protect consumers
* To maintain insurer solvency
* To prevent destructive competition

Consumers may not have complete information about the product of insurance, yet they need the product and often are required to purchase it. Because of consumers’ incomplete information, insurance regulators must ensure that the products are beneficial to consumers and available at an equitable price. In addition, inadequate information, destructive competition, and mismanagement (among other things) can threaten the solvency of insurers. Implementation and enforcement of insurance regulation is necessary to correct each of these market imperfections. If regulation can correct or reduce the effect of the market imperfections, it can encourage insurer solvency.

**Protect Consumers**

**The primary reason insurance is regulated is to protect consumers. Even if consumers inspect the insurance policies they purchase, they might not be able to analyze and understand complex legal documents**.

**Regulators help to protect consumers by reviewing insurance policy forms to determine whether they benefit the consumers and comply with state consumer protection laws**. State legislatures can set coverage standards and specify policy language for certain coverages. State insurance regulators can review policy language and disapprove policy forms and endorsements that are inconsistent with state consumer protections laws. **Insurance regulators also protect consumers against fraud and unethical market behavior. D**epartments of insurance received complaints about these behaviors:

* Producers have intentionally sold unnecessary insurance
* Producers have misrepresented the nature of coverage to make a sale
* Producers have stolen or misused insured or insurer funds
* Claim representatives have engaged in unfair claim practices, refusing to pay legitimate claims or unfairly reducing claim payments
* Insurance managers have contributed to the insolvency of insurers through their dishonesty

In addition to protection consumers against such abuses, regulators also try to ensure that insurance is readily available, especially the insurance that is viewed as a necessity. (all states now try to ensure that continuous personal auto insurance coverage is available by restricting the rights of insurer to cancel or non-renew those policies. At the same time, regulators recognize that insurers sometime must break long-term relationships with insureds whose loss exposures no longer match those the insurer wants to cover.

Insurance regulators also provide information about insurance matters so that consumers can make informed decisions.

**Maintain Insurer Solvency**

Solvency regulation is critical in protecting insureds against the risk that insurers will be unable to meet their financial obligations. Consumers and even some sophisticated business people may find it difficult to evaluate insurer’s financial ability to keep their promises. Insurance regulators try to maintain a sound financial condition of private insurers for several reasons:

* Insurance provides future protection – future claims may not be paid
* Regulation is needed to protect the public interest – adversely affect when solvent
* Insurers have a responsibility to insureds – hold substantial funds – safeguard them
* Insurers have become insolvent despite regulatory reviews – minimize them

**Prevent Destructive Competition**

Regulators are responsible for determining whether insurance rates are high enough to prevent destructive competition. At times, some insurers underprice their products to increase market share by attracting customers away from higher priced competitors. This practice drives down price levels in the whole market. When insurance rate levels are inadequate, some insurers can become insolvent, and others might withdraw from the market or stop writing new business, leading to an insurance shortage. Certain types of insurance can become unavailable at any price, such as when both products liability and directors and officers coverage became unavailable in the 1980’s.

**2 – Insurance Regulators**

**Objective**: *Summarize the regulatory activities of state insurance departments, including state insurance commissioners’ duties*.

Insurance is highly regulated industry, with regulations guiding the licensure and operations of insurers and their employees. To be successful, insurance professionals should have a basic understanding of the sources of those regulations.

The primary source of insurance regulation in state insurance departments, led by the state insurance commissioners. The National Association of Insurance Commissioners (NAIC) coordinates state-level insurance regulation, though it has no direct regulatory authority of its own. Because insurers are businesses, however, they are also subject to certain federal regulations.

NAIC is an association of insurance commissioners from the 50 US states, the District of Columbia, and the 5 US territories and possessions, whose purpose is to coordinate insurance regulation activities among the various state insurance departments.

**State Insurance Departments**

Every state has 3 separate and equal branches of government: The legislative branch makes the laws, the judicial branch (the court system) interprets the laws, and the executive branch implements the laws. Day-to-day regulation of insurance business is performed by state insurance departments, which fall under the **executive branch** of each state government. The laws that state insurance departments enforce are enacted by the legislature.

**These are the types of regulatory activities typically undertaken by state insurance departments:**

* **Licensing insurers - In addition, some states permit the insurance commissioner to deny a license to an otherwise worthy applicant if the commissioner believes that no additional insurers are needed in the state.**
* **Licensing producers, claims representatives, and other insurance personnel**
* **Approving policy forms**
* **Holding rate hearings and reviewing rate filings**
* **Evaluating solvency information**
* **Performing market conduct examinations**
* **Investigating policyholder complaints**
* **Rehabilitating or liquidating insolvent insurers**
* **Issuing cease and desist orders**
* **Fining insurers that violate state law**
* **Publishing shopper’s guides and other consumer information**
* **Preventing fraud**

**The Insurance Commissioner**

Every state Insurance Department is headed by an insurance commissioner, superintendent or director appointed by the governor or elected by the voting public. **The commissioner delegates the duties he or she is charged with to the personnel in the state Insurance Department. These duties typically include these:**

* **Overseeing the state Insurance Department’s operation**
* **Declaring orders, rules, and regulations necessary to administer insurance laws**
* **Determining whether to issue business licenses to new insurers, producers, and other insurance entities**
* **Reviewing insurance pricing and coverage**
* **Conducting financial and market examinations of insurers**
* **Holding hearings on insurance issues**
* **Taking action when insurance laws are violated**
* **Issuing an annual report on the status of the state’s insurance market and Insurance Department**
* **Maintaining records of Insurance Department activities.**

Although most commissioners are appointed, some states elect their commissioners. Which selection method better serves the public interest is a matter of debate:

Elective systems offer these benefits

* An elected commissioner is generally in office for a full term, while an appointed one is subject to dismissal
* An elected commissioner is more likely to change the Insurance Department’s stance, rather than regulating in the same manner as his or her predecessor
* An elected commission is more aware of the issues important to the public
* An elected commission is not obligated to any particular group or special interest.

Appointment systems offer these benefits

* An appointed commission has not need to campaign, and is less likely to be unduly influenced by political contributors
* An appointed commission is less likely to be swayed by ill-informed public opinion than an elected on
* An appointed commissioner is more likely to be perceived as a career government employee interested in regulation than as a politician interested in political advancement

Many commissioners were employed in the insurance business before the entered public office, and many are employed by insurers or insurance related organizations after leaving office. The expertise and understanding of insurance operations needed to regulate effectively will most likely be found in a person who has worked in the insurance business. However, some allege that such insurance commissioners have a less than objective relationship with the insurers they regulate.

*State insurance commissioners usually deny that they are overly responsive to insurers. Commissioners frequently issue cease-and-desist order, fine or penalize insurers for infractions of the law, forbid insurers to engage in mass cancellations, limit insurance rate increases, and take numerous other actions that benefit policyholders at insurers’ expense*.

**State Regulation Funding**

*State insurance departments are partly funded by* ***state premium taxes****, audit fees, filing fees, and licensing fees, but premium taxes are the major source of funding. Premium taxes are designed primarily to raise state revenues*.

**The National Association of Insurance Commissioners (NAIC)**

The NAIC coordinates insurance-regulation activities among the state insurance departments but has no direct regulatory authority. However, by providing a forum to develop uniform policy when appropriate, the NAIC has a profound effect on state regulation.

**The NAIC meets 3 times a year to discuss important issues in insurance regulation. It developed uniform financial statements that all states require insurers to file. It collects and compiles financial information from insurers for use by insurance regulators. It also assists state insurance departments by sharing financial information about insurers that are potentially insolvent and by developing model laws and regulations. The NAIC’s Financial Analysis Working Group serves as both a coordinator and failsafe mechanism for state insurance regulators as they oversee nationally significant insurers**.

**Model Laws and Regulations**

Model law is a document drafted by the NAIC, in a style similar to a state statute, that reflects the NAIC’s proposed solution to a given problem or issue and provides a common basis to the states for drafting laws that affect the insurance industry. Any state may choose to adopt the model bill or adopt it with modifications.

Model regulations are a draft regulation that may be implemented by a state insurance department if the model law is passed.

Many state’s insurance laws and regulations incorporate at least the primary concepts of the NAIC’s model laws, which results in some degree of uniformity among the states. If the model law is passed, the state may draft a model regulation. Examples would include model legislation on the regulation of risk retention groups and a model property and liability insurance rating law.

**Accreditation Program**

In addition to developing model laws, the NAICs accreditations program increases the uniformity of insurer solvency regulation across the states. **To become accredited, a state Insurance Department must prove that it has satisfied the program’s minimum solvency regulation standards**.

The NAIC’s Financial Regulation Standards and Accreditation Program has certain criteria:

* The state’s insurance laws and regulations must meet the basic standards of the NAIC’s models
* The state’s regulatory methods must be acceptable to the NAIC
* The state’s Insurance Department practices must be adequate as defined by the NAIC

**Federal Regulation**

While state governments, rather than the federal government, hold the regulatory power over insurers, some federal regulations still apply. Example, insurers are subject to federal employment laws just like any other business, and stock insurers are subject to the same regulations as other businesses that sell stock to the public.

The Federal Insurance Fraud Prevention Act protects consumers and insurers against insolvency resulting from insurance fraud. It prohibits anyone with a felony conviction involving trustworthiness from working in the business of insurance unless he or she secures the written consent of an insurance regulator. It establishes that it is illegal for an insurer, reinsurer, producer, or other similar entities to employ a felon with a conviction involving breach of trust or dishonesty. The act also identifies crimes related to the business of insurance, such as making false statements or reports about insurers to influence regulations.

**3 – Insurance Regulatory Activities: Licensing Insurers and Insurance Personnel**

**Objective:** *Describe the licensing requirements for insurers and insurance personnel*

Insurers can reap strategic advantages by anticipating regulatory requirements and process at the start of a business development plan. Noncompliance with these requirements could lead to regulatory intervention, the loss of an insurer’s license, or damage to an insurer’s reputation.

Although the review process for insurer licensing vary from state to state, all states require property-casualty insurers to receive approval before operating within the state. In addition to the authority to regulate insurer and related entities, departments of insurance (DOI) also have authority to regulate insurance producers, claims representatives, and other insurance personnel through state laws.

**Licensing Insurers**

When a state issues a license to an insurer, it indicates that the insurer meets minimum standards of financial strength, competence, and integrity. If the state’s standards for licensure change at a later time and the insurer fails to meet those new standards, its license can be revoked.

In response to complaints about the length of time regulators took to license a new insurer, regulators developed the Uniform Certificate of Authority Application (UCAA) to streamline the process.

Licensing standards vary among admitted domestic, foreign, alien, and non-admitted insurers, and risk retention groups face a set of standards of their own.

**Domestic Insurers**

If a domestic insurer obtains a license in a state other than that of its domicile, that state would consider it a foreign insurer. While a domestic insurer’s license usually has no expiration date, licenses of foreign insurers and alien insurers generally require annual renewal.

**Part of the requirements for licensure is that the insurer must be financially sound. State laws require that domestic stock insurers satisfy certain minimum capital, surplus and paid-in surplus requirements before a license if granted. Paid in surplus is the amount stockholders paid in excess of the par value of the stock.**

**For mutual or reciprocal insurers, the minimum financial requirement applies only to surplus. (A mutual insurer does not have capital derived from the sale of stock). A mutual insurer’s initial surplus can be derived from premium deposits paid by prospective policyholders, or a portion could be borrowed. Most states require mutual to have an initial surplus equal to the minimum capital and paid-in surplus requirements for stock insurers writing the same type of insurance but have set a lower minimum surplus requirement**.

For mutual insurers, many states require the organizers to have a minimum number of applications with deposit premiums for a minimum number of separate loss exposures and aggregate premium exceeding a specific amount. These requirements help guarantee that the insurer has a sufficient book of business before it officially begins operations.

**Foreign Insurers**

To be licensed in an additional state as a foreign insurer, an insurer must show that it has satisfied the requirements imposed by its home state and generally must satisfy the minimum capital, surplus, and other requirements imposed on the domestic insurers of the state for which it is applying.

**Alien Insurers**

Alien insurers (domiciled outside the US) must satisfy the requirements imposed on domestic insurers by the state in which they want to be licensed. Additionally, they usually must establish a branch office in any state and have funds on deposit in the US equal to the minimum capital and surplus required.

**Non-Admitted Insurer**

From an insured’s point of view, an admitted insurer is licensed by a state insurance department to do business in the insured’s home state. **A non-admitted insurer is not licensed in the state (though it could be an admitted insurer in other states, and may even be an alien insurer).**

*A non-admitted insurer is typically a surplus lines insurer, which is a mechanism that allows US consumers to buy property-casualty insurance from non-admitted insurers when the insurance they need is not available from admitted insurers. Non-admitted insurers writing business in the surplus lines market will not face regulatory constraints on insurance rates and forms. Surplus lines coverages commonly include products liability, professional liability, employment practices liability, special events, and excess and umbrella policies*.

Under surplus lines laws, a non-admitted insurer might be permitted to transact business through a specially licensed surplus lines producer if the insurance is not readily available from admitted insurers, the non-admitted insurer is considered acceptable, and the producer has a special license authorizing him or her to place such insurance.

An acceptable non-admitted insurer generally must file a financial statement that the insurance commissioner finds satisfactory; supply documentation of transactions to state regulators; obtain a certificate of compliance from its home state or country; and it an alien insurer, maintain a trust fund in the US.

The NAIC maintains an International Insurers Department (IID) to examine non-admitted alien insurer’s financial condition, trust funds, and trust deposits. The IID maintains a list of alien insurers that meet its standards, known as the NAIC Quarterly Listing of Alien Insurers. The IID standards cover 4 primary areas:

* Capital and surplus requirements
* Trust fund requirements
* Biographical affidavits from the directors and officers of insurers
* Annual filing of insurer’s audited financial statements

The IID list is recognized as a credible list of financially sound insurers, and a number of states used the list as de facto eligibility list for alien non-admitted insurers. Under provision of the federal Non-admitted and Reinsurance Reform Act (NRRA), no state may prohibit a licensed surplus lines broker from “placing or procuring” insurance with an insurer on the list. In addition, the NRRA initiated several state-level reforms that made the surplus lines market more efficient and established a modern, consistent, and more effective framework for surplus lines regulation.

**Risk Retention Groups**

A Risk retention group is a special type of assessable mutual insurer enabled by the 1986 Liability Risk Retention Act. Risk retention groups are often formed under state captive laws, which generally establish lower capital and surplus requirements for captives than for traditional property-casualty insurers. Once licensed as a commercial liability insurer under the laws of at least on state, a risk retention group can write insurance in other states without a license by filing the appropriate notice and registrations forms with the non-chartering state. *A risk retention group can only write commercial liability insurance for its members and may not write other lines of business*. However, in a non-chartering state, a risk retention group might be subject to some state laws, such as unfair claims settlement practice laws, and to premium taxes. They may also be required to become a member of a joint underwriting association or a similar association through which insurers share losses in such areas as assigned-risk auto insurance.

Some state regulators have expressed concerns about the financial security of risk retention groups, particularly when the group providing the insurance is licensed in another state. Congress helped address these concerns by allowing the licensing state to request and, if necessary, mandate an examination of a group’s financial condition, even when the commission has no reason to believe the group is financial impaired.

**Licensing Insurance Personnel**

* **Producers** – producers must be licensed as a resident producer in each state where they do business.
  + Provisions in the Gramm-Leach Bliley (GLB) Act have led to greater licensing reciprocity among states, although the ultimate goal of regulators is to move beyond reciprocity and to resolve issues related to uniformity in producer licensing.
  + The development of the National Insurance Producer Registry (NIPR) has eliminated many of the inconveniences that arise from multistate regulatory system. The NIPR is a unique public-private partnership that supports the work of the states, Puerto Rico, the District of Columbia, the US Virgin Islands, and the NAIC in making the producer-licensing process more cost effective, streamlined, and uniform for the benefit of regulators, insurance producers, insurers, and consumers. NIPR’s vision is to provide a single electronic communication network producers can use to meet all aspects of the licensing and appointment process. NIPR developed and implements the Producer Database (PDB) to the NIPR gateway (an electronic database that provides participating state regulatory licensing systems with one common repository of producer information. The NIPR gateway is a communication network that links state insurance regulators and the entities they regulate to facilitate the electronic exchange of producer information.

The National Association of Registered Agents and Brokers Reform Act of 2015 (NARABII) was a second attempt by the federal government to establish a centralized organization that, with the compliance of jurisdictions throughout the US, would work with individual states to streamline the nonresident-producer-licensing process. Under NARBAB, producers would need to be licensed only as a resident producer by their state to qualify as a nonresident producer in any other participating state.

* **Claims Representatives - Some states require claim representatives to be licensed so that they are aware of prohibited claims practices, have a minimal level of technical knowledge and skill, and understand how to handles insured’s claims fairly**.

Public adjuster, who represent insureds for a fee, are generally required to be licensed to ensure technical competence and protect the public.

* **Insurance Consultants -** Insurance consultants give advice, counsel, or opinions about insurance policies. Some states require insurance consultants to be licensed. Separate examination are usually required to be an insurance consultant in both life-health and property-casualty.

**4 – Insurance Regulatory Activities: Monitoring Insurer Solvency**

**Objective:** *Describe the methods that regulators use to maintain the solvency of insurers*

Insurers must remain solvent to pay their customer’s covered claims. To ensure this, the United States’ regulatory framework has made provisions to monitor insurers’ financial strength.

Monitoring insurer solvency protects insureds and the public by reducing the insolvency risk and protecting the public against loss when insurers fail. Whether directly or indirectly, insurers and consumers both pay for the cost of regulation; however, the long-term result is keeping insolvencies infrequent and manageable.

**Methods to Maintain Solvency**

State insurance regulators are assisted by the NAIC, an organization of the chief insurance regulatory and official from each state, the District of Columbia, and five US territories. The NAIC provides financial, actuarial, legal, technological, research, and economic expertise to state regulators to assist them in meeting regulatory goals.

The mission, or purpose, of US insurance regulation is to protect the interests of the insured and those who rely on the insurance coverage provided to the insured, while also facilitating an effective and efficient marketplace for insurance products. To accomplish this, insurance regulators must have appropriate regulatory authority and be able to operate without too much influence from insurers or other groups.

The US regulatory framework relies on an extensive system of peer review, featuring frequent communication and collaboration to provide the necessary checks and balances needed to make the system work. Much of the collaboration occurs through the NAIC, where the diverse perspectives of its members are reflected in solutions embodied in model laws and regulations. These solutions have resulted in a risk-focused approach that is constantly evolving to meet changing local, national, and international developments.

Uniformity of approach to financial regulation has been facilitated by the NAIC accreditation program. As part of the peer review process, the accreditation programs subjects state insurance regulators to a thorough and comprehensive review to determine whether the state has met minimum baseline standards of solvency regulation.

Financial Solvency Core Principles:

* Regulatory reporting, disclosure and transparency
* Off-sit monitoring and analysis
* On-site, risk-focused examinations
* Reserves, capital adequacy, and solvency
* Regulatory control of significant, broad-based, risk-related transactions/activities
* Preventive and corrective measures, including enforcement
* Exiting the market and receivership

**The US Regulatory framework has evolved over time into the risk-focused approach used by regulators today. A wide variety of insurers, ranging from small to large, serve a variety of state-based, regional, and national markets. This wide range of regulated entities calls for a flexible approach to regulation that focuses on the risks undertaken by each regulated entity. Here are some examples of solvency requirements insurers must comply with**

* **Insurer must submit annual and quarterly financial statements to the domestic regulator and the NAIC using a prescribed format called the annual statement or the blank. The NAIC maintains a data warehouse for use by state financial regulators.**
* **Insurers are required to use the NAICs manual an instruction for consistency of accounting treatment and financial reporting**
* **Most insurers (except the very small) must submit their financial statement to a certified public accountant for audit and have an actuary attest to the accuracy of reserve estimates**
* **Insurers must perform a risk-based capital (RBC) calculation and report the results to regulators. The RBC calculation uses a standardized formula to benchmark a specific level of regulatory actions for weakly capitalized insurers. The RBC amount, based on industry experience, explicitly considers the size and risk profile of the insurer.**
* **Insurers are required to adhere to state minimum capital and surplus requirements**
* **State investment laws limit the types and quantity of investments an insurer may make, encouraging insurers to maintain a conservative and diversified investment portfolio**
* **Sates laws specify limitation on the amount on any single insured risk a property-casualty insurer may underwrite**
* **Treatment of reinsurance is governed by the NAIC Credit for Reinsurance Model Law, which imposes standards on credits allowed to the reporting insurer**.

**Liquidation of Insolvent Insurers**

**If an insurer falls into insolvency, the insurance commission places it in receivership – at which time, another party, typically the insurance commissioner, manages the insurer. With property management, successful rehabilitation might be possible. If the insurer cannot be rehabilitated, it is liquidated according to the state’s insurance code. Many states now rehabilitate and liquidate insolvent insurers according to the Uniform Insurers Liquidation Act, the Insurers Rehabilitation and Liquidation Model Act, and the Insurer Receivorship Model Act**.

**State Guaranty Funds**

**Guaranty funds do not prevent insurer insolvency, but they mitigate its effects. All states have property-casualty insurance guaranty funds that pay some of the unpaid claims of insolvent insurers licensed in the particular state.**

Typically, insurers doing business in the state are assessed their share of the unpaid covered claims of the insolvent insurer. Although the amounts involved are not trivial, they still represent a very small percentage of total premiums.

State guaranty funds vary by state however, these characteristics are common.

* Assessments are made only when an insurer fails. The definition of failure varies by state
* Policies usually terminate within 30 days after the failure date
* Claims coverage varies by state – no state guaranty fund covers reinsurance or surplus insurance (except NJ)
* Claims are subject to maximum limits
* Most states provide a refund of unearned premiums
* Most states apply a $100 deductible to unpaid claims
* Most states divide their guaranty funds into separate accounts, usually auto, workers compensation, and other types of insurance
* Assessment recovery varies by state

**Reasons for Insolvency**

It is difficult to state the exact reasons for an insurer’s failure. Usually, there isn’t a single event or mistake that cause an insurer to become insolvent; rather, poor management and adverse events combine to cause insolvencies. Increased competition among insurers, leading to lower premium prices during soft phases of the underwriting cycle, often contributes to an increase in insurer insolvencies.

**Experts have identified these factors that frequently contribute to an insurers’ insolvency:**

* **Rapid premium growth**
* **Inadequate insurance rates**
* **Inadequate reserves**
* **Excessive expenses (high underwriting expenses)**
* **Lax controls over managing general agents**
* **Uncollectible reinsurance**
* **Fraud**

**Poor management is at the roof of most of these factors.**  *A combination of inadequate insurance rates and lax underwriting standards can start deterioration in a book of business. If these problems are not detected and corrected promptly, the decay in the quality of the business accelerates*.

*Rapid premium growth precedes nearly all major insolvency. Rapid growth by itself is not harmful, but it reduces the margin for error in insurers’ operations – and it usually indicates larger issues. If insurance rates are inadequate and losses understated, net losses and capital deterioration rise more quickly than management can effectively respond to*.

**5 – Insurance Regulatory Activities: Regulating Insurance Rates**

**Objective:** *Examine the goals of insurance rate regulation, the major types of state rating laws, and the reasons supporting and opposing rate regulation*.

States use a variety of approaches to regulate insurance rates, but they all have the same broad fairness goals: to ensure the financial health of insurers and to protect consumers who could be hurt by an organization’s financial collapse. Each approach has its own benefits and drawbacks.

**Insurance Rate Regulation Goals**

**Rate regulation ensures that rates are adequate, not excessive, and not unfairly discriminatory.**

* **Adequate – When an insurers offers a specific type of insurance, the rates it charges should be high enough to pay for all the claims and expenses the insurer will encounter for that type of insurance**. This requirement helps maintain and insurer solvency. Several factors complicate the regulatory goal or rate adequacy
  + An insurer usually does not know what its expenses will be when a policy is sold so it may become inadequate if there is an unexpected increase in claims frequency
  + Insurer might charge inadequate rates in response to strong price competition
  + State rate approval systems may not approve a request for rates an insurers believes are adequate for public policy reason or disagreement over the level or requested rates
  + Natural and other unanticipated catastrophic events could lead to higher losses
  + Regulatory actuaries and insurer actuaries may disagree about the assumptions used to determine trends or account for socioeconomic components of a proposed rate change
* **Not Excessive – Although rates should be adequate, they should not be excessive just so insures can earn disproportionate or unreasonable profits**. Regulators have considerable latitude and discretion in determining whether rates are excessive:
  + number of insurers selling a specific coverage in the rating territory
  + Relative market share of competing insurers
  + Degree of rate variation among the competing insurers
  + Past and prospective loss experience for a given type of insurance
  + Possibility of catastrophe losses
  + Margin for underwriting profit and contingencies
  + Marketing expenses for a given type of insurance
  + Special judgement factors that might apply to a given type of insurance

Regulators sometimes use the fair rate of return approach in determining whether an insurers’ rates are adequate or excessive. This approach is based on the premise that an insurer should expect at least some minimum rate of return on the equity invested in its insurance operations and that a fair rate of return should be similar to the rate of return on other types of businesses – especially if insurers are to attract investment capital. However, regulators and investors often disagree what constitutes a fair rate of return for insurers.

* **Not Unfairly Discriminatory** – Discriminatory carries negative connotations and is generally associated with prejudicial behavior, but it also has a secondary, neutral meaning, focused on the ability to differentiate among like items. **Fair discrimination means that an insurer should charge substantially similar rates for loss exposures that are roughly similar with respect to expected losses and expenses. If similar exposures were to be charged substantially different rates, that would constitute unfair discrimination. The same age, similar vehicles, same rating territory, with the same limits should be charged the same rate. Discrimination is essential to insurance rating.**

**Types of Rating Laws**

A state’s rating laws influence how it achieves its three major rate regulation goals and the rates property-casualty insurers can charge. Rating laws apply not only to rates for a new type of insurance but also to changes in rates for existing types. The major types of state rating laws are these:

* Prior-approval laws require rates and supporting rules to be approved by the state Insurance Department before they can be used. In some cases, a prior-approval law contains a deemer provision, which means that a filing is deemed approved if the insurer has not heard from the regulator within a given time. (usually 30 days)
* *File-and-use laws allow the insurer to use the new rates immediately after filing with the state*. The department has the authority to disapprove the rates if they cannot be justified.
* Use-and-file laws, a variation of the file-and-use laws, allows insurers to use the new rates and later submit filing information that is subject to review.
* No Filing laws (information filing, or open competition) do not require insurers to file rates with the state. Market prices driven by the economic law of supply and demand, rather than the discretionary acts of regulators, determine the rates and availability. The goals of adequate, non-excessive, and equitable rates still apply. Insurers might be required to furnish rate schedules and supporting statistical data to regulatory official and the state as the authority to monitor competition and disapprove if necessary.
* Flex rating laws require prior approval only if the new rates exceed a certain percentage above (or below) the rates filed previously. Typically, a range of 5-10% is permitted. Flex rating permits insurers to make rate adjustments quickly in response to changing market conditions and loss experience, but it prohibits wide swings within a short period of time. Flex rating can also restrict insurers from drastically reducing rates to increase market share. The result should be smooth insurance pricing cycles.

Open competition might apply as long as insurers meet certain tests, such as providing evidence of competitive markets or keeping rate increases to less than 25% per year. Insurers that fail to meet these criteria would be subject to prior approval or another type of regulatory review.

**6 – Insurance Regulatory Activities: Regulating Insurance Policies**

**Objective**: *Explain how the contract language contained in insurance policies is regulated*

Regulation of insurance policies helps to protect insurance consumers, who often may not understand complex policy language. Regulation can protect insureds from policies that are narrow, restrictive, deceptive, or that fail to comply with state laws and regulations.

Contract language contained in insurance policies is regulated through legislation and insurance department’s rules, regulations, and guidelines. Regulation may require certain forms, provisions, or standards, or it may prohibit certain provisions.

**Legislation**

Insurance policy regulation starts with state legislature passing laws that control the structure and content of insurance policies sold in the state. **Legislative policy regulation affects these five areas: Standard forms, mandatory provisions, prohibited provisions, forms approval, or readability standards.**

**Legislation might require insurers to use a standard policy to insure property or liability loss exposures. A Standard policy is one policy all insurers must use if a coverage is sold in the state.**

**Legislation might also require that certain standard mandatory policy provisions appear in certain types of policies. The required and optional provisions might be based on a model bill developed by the NAIC.** Example, sate usually require that workers compensation, no-fault auto insurance, and often uninsured motorist coverage contain mandated policy provisions and the state may mandate that those provisions meet certain minimum standards, providing a least a basic level of protection.

**Legislation may mandate that policies be filed and/or approved by the state to protect policyholders against ambiguous, misleading, or deceptive policies. Many states that require a policy be submitted for approval before it is used,** however, if a specified period elapses and the policy has not been disapproved, the policy is considered approved. This prompt quicker review. The purpose of such approval is to encourage a prompt review of the policy. However, it can cause a perfunctory review.

**Legislation might require that insurance policies meet a readability test. Legislation may specify policy style and form as well as size of print**. Readability legislation has influenced the drafting of both personal and commercial insurance policies, but readability tests do not necessarily measure how well the policies can be understood.

**Policy Rules, Regulations, and Guidelines**

**State insurance department implement specific directives from the legislature or exercise the general authority they have to regulate insurance policies. Administrative rules, regulations and guidelines can be stated in:**

**1.) Regulations communicated by the state insurance department to insurers**

**2.) Informal circulars or bulletins from the same source, and**

**3.) Precedents set during the approval process**

**For example, the state insurance department might require specific wording in certain policy provisions or might notify insurers of certain types of policy provisions with be approved**.

**Courts**

Although the courts do not directly regulate insurers, they do influence them by determining whether insurance laws are constitutional and whether administrative rulings and regulations are consistent with state law. The court also interpret ambiguous and confusing policy provisions, determine whether certain losses are covered by the policy, and resolve other disputes between insurers and insureds over policy coverages and provisions.

Court decisions often lead insurers to redraft their policy language and to modify provisions. For Example, based on the legal doctrine of concurrent causation, certain courts ruled that if a loss under a risk of direct physical loss (formerly “all-risks”) policy is caused by two causes of loss, one of which is excluded, the entire loss is covered. As a result of this doctrine, insurers were required to pay certain flood and earthquake claims they had believed were excluded by their property insurance policies. Subsequent revision of the language in many such property policies explicitly excluded coverage for flood and earthquake losses in cases in which a non-excluded cause of loss contributed to the loss.

**7 – Insurance Regulatory Activities: Market Conduct and Consumer Protection**

**Objective**: *Summarize the regulation of insurance market conduct and consumer protection*

Consumer protection lies at the heart of insurance regulation. Regulators help protect insurance consumers from unfair practices and promote competition within the insurance marketplace. Regulators have monitored 3 key areas of market conduct: Producer practices; Underwriting practices; Claims practices.

However these traditional market conduct examinations have begun to play less of a role in regulation as regulators have moved toward market analysis to maintain the industry’s health.

**Monitoring Market Conduct**

Laws regarding unfair trade practices prohibit abusive practices. Currently, all US jurisdictions except American Samoa and Guam have laws against unfair trade practices. Unfair trade practices acts at the state level regulate the trade practices of the business of insurance as required under the McCarran Act.

If an insurer is accused of engaging in unfair trade practices, the case can be decided by the insurance commission of the state in which the practice occurred. An insurer that violates the unfair trade practices act is subject to at least on, if no both, of 2 penalties:

* Fine per violation – fines are often increased significantly if the activity is considered flagrant, with conscious disregard for the law
* Suspension or revocation of license – this may occur if the practice occurred frequently and if the insurer’s management know or should have known.

If an insurer disagrees with the commissioner’s findings, it can usually file for judicial review. If the court agrees with the commissioner, the insurer must obey the commissioner’s orders.

The NAIC Model Unfair Trade Practices Act prohibits insurers from any activity that would restrain trade or competition in the business of insurance. The act also prohibits an insurer from misrepresenting its own or another insurer’s financial status. Additionally, there are numerous provisions in the Model Act to protect insurance consumers.

The key insurer market conduct areas that are regulated by the Model Act and state-level unfair trade practices acts include producer practices, underwriting practices, and claims practices.

**Producer Practices**

**A producer might be penalized (through fines, license revocations, and so forth) for engaging in practices that violate the state’s unfair trade practices act**:

* Dishonesty or fraud – embezzle premiums paid by insureds or misappropriate claim funds
* Misrepresentation – misrepresent the losses that are covered by an insurance policy to induce a client to purchase that policy under false pretense
* Twisting – induce an insured to replace one policy with another, to the insured’s detriment. This is a special form of misrepresentation called twisting
* Unfair discrimination – any act that unfairly favor one insured over another
* **Rebating – the practice of giving a portion of the producer’s commission or some other financial benefit to an individual as an inducement to purchase a policy. Rebating is illegal in almost all states.**

**Underwriting Practices**

Insurance regulators attempt to prevent improper underwriting that could result in insurer insolvency or unfair discrimination against an insurance consumer. To protect consumers, insurance regulators take actions such as these:

* Constrain insurers’ ability to accept, modify, or decline applications for insurance – to increase availability, states often require insurers to provide coverage for some loss exposures they might prefer not to cover
* Establish allowable classifications – Regulators limit the ways in which insurers can divide customers into rating classifications. Example – unisex rating is required in some states for auto insurance, promoting social equity rather than actuarial equity.
* Restrict the timing of cancellations and non-renewals – provide adequate notice

Examples of unfair trade practices with respect to underwriting:

* Discrimination unfairly when selecting loss exposures
* Misclassifying loss exposures
* Cancelling or non-renewing policies contrary to statutes, rules, and policy provisions
* Using underwriting rules or rates that are not on file with or approved by the insurance department in the states in which the insurer does business
* Failing to apply newly implemented underwriting and rating factors to renewals
* Failing to use correct policy forms and insurance rates
* Failing to use rules that are state specific

**Claims Practices**

All states prohibit certain claims practices by law. Claims practices are regulated to protect insureds and maintain public confidence in the insurance promise: to pay valid claims promptly and fairly. Apart from regulatory penalties, failure to practice good-faith claims handling can lead to claims for damages that allege bad faith on the insurer’s part. Unfair claims practices law prohibits unethical and illegal claims practices. The laws are generally patterned after the NAIC Model Unfair Claims Settlement Practices:

* Knowingly misrepresenting important facts or policy provisions
* Failing to properly investigate and settle claims
* Attempting to settle a claim for less than the amount that **a reasonable person** believes he or she is entitled to receive based on advertising material that accompanies or is part of the application
* Failing to approve or deny coverage of a claim **within a reasonable period after a proof-of-loss** statement has been completed.

In some cases, courts have ruled that an insurer’s improper claims handling constitutes not only a breach of contract or violation of regulations, but also an independent tort – bad faith. Legal remedies for bad-faith actions can lead both to first-party actions (involving the insured) and to third party actions (involving a claimant). An insurer that violates good-faith standards can be required to honor the policy’s intent (paying the claim) and pay extracontractual damages, such as emotional distress and attorney fees.

**Market Analysis**

**Insurance regulator are moving away from traditional market conduct examinations in favor of market analysis. Market analysis enables regulators to identify general market disruptions, promotes uniform analysis by applying consistent measurements between insurers, and facilitates communication and collaboration among regulators from different states. Traditional market conduct examinations focused on company specific issue including producer practices, underwriting practices, and claims practices**.

One of the fundamental components of market analysis is the collection of regulatory information from insurers using the Market Conduct Annual Statement (MCAS). The MCAS allows regulator to monitor, benchmark, and analyze the insurance market in almost every jurisdiction in the US on a state or national level. It began as a source of information on life insurance and annuities alone, but has since been used to track homeowners, auto, and long-term care.

**Ensuring Consumer Protection**

While all insurance regulatory activities protect insurance consumers at least indirectly, certain activities are designed specifically to support consumers. For example, state insurance departments respond to consumer complaints and also inform and educate consumers.

**State insurance departments often assist with complaints about rates or policy cancellations or with consumers’ difficulty finding insurance. Although state insurance department usually have no direct authority to order insurers to pay claims when facts are disputed (such disputes are typically resolved through the courts), most state insurance departments can investigate and follow up on a consumer complaint, at least to the extent of getting a response from the insurer involved.**

Many states compute complaint ratios and make them readily available to consumers through the internet. The stats also publish shoppers’ guides (regarding the cost of insurance) and other forms of consumer information, much of which can be found online.