CATO HANDBOOK FOR CONGRESS

POLICY RECOMMENDATIONS FOR THE 108TH CONGRESS

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37. Insurance Regulation and Government Insurance

Congress should

- keep the federal government out of the business of regulating insurance companies;
- authorize tax-deferred treatment of private insurers' catastrophe reserves; and
- reduce the scope of current government insurance programs, terminate the new terrorism reinsurance program within three years (if not sooner), and not launch any other new federal reinsurance schemes.

In recent years, most congressional efforts to expand the federal role in insurance regulation and insurance assistance have focused on the mounting cost of federal outlays for disaster assistance involving earthquakes, floods, hurricanes, droughts, and other weather-related events. When devastating losses from the terrorist attack on the World Trade Center rocked private insurance markets in the fall of 2001, they also revived political momentum for even broader federal reinsurance guarantees to cover the depleted reserves of insurers and fill growing gaps in private reinsurance coverage.

The 107th Congress approved creation of a federal backstop for private-sector terrorism insurance coverage in response to the events of September 11, 2001. Like other federal insurance programs, that approach to shielding the private sector from loss runs the risk of creating sizable taxpayer-financed subsidies that would undermine private-sector incentives for risk management. The broader, long-run issue is the extent to which the federal government should provide reinsurance protection for large losses from disasters, whether natural or man-made, as opposed to taking actions that would expand private-sector capacity for insuring such losses. The preferred alternative is to reduce the scope of current federal insurance programs with their inherent subsidies and disincentives for risk management, avoid creating new federal insurance and reinsurance programs, and modify the tax code to reduce double taxation of the income from the large reserves that insurers must hold to credibly insure large losses from catastrophic events.

Government-provided programs for crop insurance and flood insurance, as well as other interventions in private disaster insurance markets, often are justified as necessary to overcome the failure of private markets to offer adequate and affordable disaster insurance. Defenders of government insurance programs claim that they reduce dependence on ''free'' disaster assistance and promote efficient risk management by property owners and farmers.

But government policies are the cause of, not the cure for, the limited supply and narrow scope of private-sector disaster insurance. Demand for private coverage is low in part because of the availability of disaster assistance, which substitutes for both public and private insurance. Moreover, a government that cannot say no to generous disaster assistance is unlikely to implement an insurance program with strong incentives for risk management. The subsidized rates and limited underwriting and risk classification within current federal government insurance programs aggravate adverse selection, discourage efficient risk management, and crowd out market-based alternatives.

Federal tax policy reduces supply by substantially increasing insurers' costs of holding capital to cover very large but infrequent losses. State governments also intrude on insurance markets by capping rates, mandating supply of particular types of insurance, and creating state pools to provide catastrophe insurance or reinsurance coverage at subsidized rates.

By reducing both the supply and demand sides of private insurance protection, government intervention leads to greater reliance on politically controlled disaster assistance and higher costs for taxpayers. A clear outcome is larger government.

Disaster Assistance vs. Government Insurance

The federal government seems unable to withhold disaster assistance from persons who fail to buy private or government insurance. Government insurance might be seductive to some efficiency-minded economists because, unlike free disaster assistance, it should encourage property owners and farmers to reduce risky activities and take loss-limiting measures. In practice, however, the same political pressures that make disaster assistance inevitable prevent the government from offering insurance at prices that reflect the full costs of coverage. Given low demand, government disaster insurance must be subsidized heavily or coverage must be compelled. By subsidizing high-risk properties, adopting loose underwriting and risk classification rules, and continuing to make disaster assistance widely available, the federal government discourages efficient risk management.

If the scope of insurance coverage were relatively narrow and the total cost of subsidies were small, government insurance would reduce costs. But as coverage and subsidies increase, there is a point at which the total cost of a subsidy-and-assistance program exceeds that of an assistance-only program. It is not obvious that a disaster-assistance-only program would cost more.

Private-Sector Risk Bearing vs. Inefficient Government Insurance

The terrorist attack on the World Trade Center depleted capital reserves of insurers and reinsurers and contributed to significant short-run turmoil in property insurance markets. The losses aggravated ongoing price increases that began in late 1999 following a decade-long ''soft'' insurance market (marked by low prices and expanded coverage). Insurers subsequently filed for and most states approved exclusions of most terror losses in standard form property-casualty insurance policies, except workers' compensation insurance. As the events of September 11 were digested and no new attacks occurred, a substantial amount of new capital flowed into the sector. A number of new entities were formed to sell property insurance and reinsurance. Coverage for losses from terror generally is available, albeit at a steep price in many instances, particularly for large buildings in major cities. In response to those price increases, many properties are being insured for lower limits of coverage and in some cases are going ''bare'' (without any insurance).

After the insurance, banking, construction, and real estate industries vigorously pressed for federal intervention to create a ''backstop'' for private-sector coverage for losses from terrorist attacks, the Bush administration proposed direct federal reimbursement of a large proportion of terrorist claims for three years. In November 2001 the House passed a complicated bill that would advance federal funds to pay a large proportion of losses above individual insurer and industrywide retentions but would require insurers to pay back any federal funds with premium-based assessments and possible direct surcharges on policyholders. The House bill included stiff tort limitations to prevent profiteering by the plaintiffs' bar. Last June the Senate passed its own bill, which authorized the federal government to pay a large proportion of losses above specified individual insurer and industrywide loss thresholds, without any payback provision or tort limitations. In November, Congress finally approved final legislation that reflected most of the Senate bill's approach, with low loss thresholds, very limited payback provisions, and no significant restrictions on tort lawsuits.

The World Trade Center's destruction and the subsequent debate over federal intervention in terrorism insurance highlight fundamental issues associated with government insurance or reinsurance. Insurance involves a basic tension between risk-sharing protections and risk-reducing incentives. The public and policymakers appreciate the benefits of risk sharing; the dulling of incentives to reduce risky activity and take precautions to control loss that often accompanies insurance is less visible. Private insurance markets limit that moral hazard by charging premiums that are closely aligned with a policyholder's risk of loss, thus providing appropriate incentives to reduce loss. Insurers that fail to price policies accurately suffer adverse selection and lose money. Insurers also have strong incentives to settle claims efficiently.

Government insurance operates differently. It invariably results in subsidized rates that are crudely related to the risk of loss, thus aggravating moral hazard and adverse selection. Incentives for economy in claim settlement are relatively weak. In the two main federal insurance programs, crop and flood insurance, the government insures a disproportionate number of high-risk entities at inadequate rates, thus requiring large taxpayer subsidies. Rather than lose money and disappear, federal insurance programs tend to lose money and expand, crowding out viable private-sector coverage. Risky activity and the amount of losses increase as parties adapt risk management to the terms of subsidized coverage. Subsidized federal insurance or reinsurance of large losses that result from disasters—whether natural or man-made—can make citizens more vulnerable to harm by discouraging rational responses to those losses and the risk of future loss.

In the wake of the new federal terrorism insurance program, pressure for Congress to enact federal reinsurance for natural disasters will likely resurface, such as the Homeowners' Insurance Availability Act, which would authorize the secretary of the treasury to sell ''excess-of-loss'' reinsurance contracts for insured natural catastrophe losses on residential properties. That pressure should be resisted. There is no need for such a federal reinsurance program. Although temporary pressure has been exerted since the events of September 11, private reinsurance capacity has expanded substantially since the early 1990s, and the development of new financial instruments to fund catastrophe coverage has further expanded the supply of private catastrophe insurance and reinsurance. The proposed reinsurance program would crowd out much private-sector coverage and would encourage creation of state insurance programs. As with federal flood and crop insurance, pressure would likely build for artificially low prices and program expansion—with similar results: less private coverage, higher costs for taxpayers, and poorer risk management by property owners.

Worst-case scenarios can always be imagined that overwhelm the current capacity of private insurers and capital markets. However, we should not pretend that levels of catastrophic risks that truly are ''uninsurable'' could be managed efficiently with hastily constructed public-private ''partnerships'' that masquerade as insurance and corrupt private markets. To handle those most unlikely events, it would be better if private insurers encouraged the federal government to set clearer *ex ante* guidelines for the *ex post*, compassionate relief needed for eligible injured parties and pressed for removal of tax and regulatory disincentives that impede the growth of private-sector risk-bearing capacity.

Expanding the Supply of Private Disaster Insurance

Given the past failures of Congress to exercise self-restraint and resist political demands for more subsidized government insurance, a more fruitful reform strategy should focus on expanding the supply of prefunded capital reserves that stand behind private insurance—both to strengthen the role of insurers as efficient risk managers and to serve as a necessary ''buffer'' against the risk of insurer insolvencies. Congress should reexamine in particular the counterproductive impact of federal tax policy on the availability of private insurance coverage for low-probability, high-cost events.

Federal corporate income taxes increase insurers' costs of holding capital and, in turn, the premiums they must charge for a given level of disaster coverage. Because private insurers cannot set up tax-deferred reserves, they must increase premiums by enough to cover the taxes on investment income in order to generate returns equivalent to those that investors could earn elsewhere. This tax disadvantage is especially pronounced for disaster insurance because insurers must hold huge amounts of capital to pay claims that have a low probability of occurrence. Moreover, premium increases to cover taxes on investment income result in higher expected before-tax income, thus further increasing expected taxes and premiums. Loss carry-back and carry-forward provisions in the tax code result in high taxes in years when disaster claims are low but yield limited deductions in years with high claims.

The tax loading on premiums is inversely related to the probability of loss and significantly increases the premium rates needed to cover large disaster losses that have a low probability of occurrence. Insurers and reinsurers can reduce the tax loading in disaster insurance premiums by, for example, substituting debt for equity financing; purchasing reinsurance from non-U.S. insurers; or, at least for the time being, moving operations offshore. The tax code nonetheless discourages the private supply of coverage for relatively rare but potentially large catastrophe losses. It contributes to possibly severe short-run consequences in the event of a large disaster, namely, increased insurer insolvency, higher rate increases, more cancellations and nonrenewals, and pressure for more government intervention.

A federal reinsurance program would threaten to crowd out much private-sector coverage, because its coverage thresholds to trigger payments would be far too low compared to current private-sector capacity. The federal government also inevitably would extend its reach to the pricing and underwriting of individual policies backed by federal reinsurance.

Preserve State Regulation of Competitive Insurance Markets

Concern over state regulation of property-casualty insurance rates and policy forms (contract language) for all types of insurance already has generated pressure for Congress to enact legislation that would allow insurers to obtain an optional federal charter and be regulated primarily by federal regulators. Despite the obvious sins of state regulation as practiced in some states, the potential efficiencies from optional federal chartering are speculative and small. The risks, however, are large, including the possibility of inefficient regulation of rates and underwriting at the federal level, which would undermine incentives for private risk management, and creation of a broad federal guaranty of insurers' obligations patterned after federal deposit insurance, which would aggravate moral hazard and undermine incentives for safety and soundness in private insurance markets. The preferred alternative to federal chartering and regulation of insurance is additional reforms at the state level.

The McCarran-Ferguson Act was enacted in 1945 in response to the Supreme Court's decision that insurance transacted across state lines was interstate commerce and subject to federal antitrust law. The ruling challenged the legitimacy of state regulation and insurers' cooperative arrangements to fix prices through rating bureaus. The act stipulates that state regulation is in the public interest, that federal law does not apply to insurance unless specifically indicated, and that federal antitrust law does not apply to insurance for activities that are regulated by the states and that do not involve boycott, coercion, or intimidation.

Although the long-term trend in property-casualty insurance regulation has been toward greater reliance on market competition and less reliance on rate regulation, progress has been slow. The last decade has seen significant, albeit uneven, progress toward greater reliance on competitive pricing. The sporadic movement toward less rate regulation reflects (1) expanded recognition of rate regulation's inability to make insurance more affordable and the adverse effects of attempting to do so; (2) increased concern with the direct and indirect costs of state regulation of prices, policy forms, and producer licensing; (3) accumulating evidence that competitive rating works; (4) broader support for competitive rating by insurance companies that have tasted regulatory rate suppression; and (5) favorable trends in claim costs for auto and workers' compensation insurance in the 1990s, which allowed deregulation to be accompanied by rate reductions or slower rate increases.

Prior approval regulation in some states is relatively benign. The main problem lies in states where regulation materially delays rate and form changes, chills competition and innovation, produces chronic cross-subsidies, or has more than one of those effects. When it comes to insurance, some voters are inclined to support command-and-control policies, even if they reject such policies generally. Sizable rate increases and "unaffordable" rates create large constituencies that favor rate suppression, especially when its adverse consequences may be opaque in the short run. Regulatory bureaucracies resist reform. Interest groups that benefit from high claim costs may oppose regulatory reform in some states out of fear that it might increase pressure for public policies to control costs (such as tort reform).

Problems with Optional Federal Chartering

The enactment of the Graham-Leach-Bliley Act (GLB) in 1999 increased debate over the residual sins of state regulation, in particular the direct and indirect costs of state regulation of rates, forms, and producer licensing in an environment of financial modernization and global competition. Representatives of many large property-casualty insurers specializing in business insurance and their main trade association (the American Insurance Association) advocate optional federal chartering and regulation as a means of regulatory modernization (that is, of escaping inefficient state regulation of rates and certain forms). Representatives of many life insurance and annuity companies and the American Council of Life Insurers favor optional federal regulation as a way to escape inefficient form regulation and compete more effectively with banks that offer similar products.

The American Bankers Insurance Association has proposed an optional federal chartering bill patterned largely after bank regulation. Rep. John LaFalce (D-N.Y.) and Sen. Charles Schumer (D-N.Y.) also proposed optional federal chartering bills with a number of similar features. The American Insurance Association has advanced optional federal chartering for property-casualty insurers, and the American Council of Life Insurers has urged chartering legislation for life and annuity insurers.

State responses to increased concern about antiquated regulatory practices and to the threat of federal chartering include the elimination of prior approval regulation of rates and policy forms for ''large'' commercial buyers in many states. Many states also approved laws to meet GLB provisions dealing with reciprocity for nonresident producer licensing and to prevent federal licensing of producers. The National Association of Insurance Commissioners is pressing for an interstate compact for one-stop approval of policy forms for life, annuity, disability, and long-term-care insurance and for modernization of rate filing and review processes for property-casualty insurance.

In theory, optional federal chartering of insurers might enhance competition by streamlining, centralizing, or eliminating antiquated regulations of multistate insurers and producers. It might provide federally chartered insurers with a broad exemption from state rate and form regulation. It might promote beneficial regulatory competition between federal and state regulators. It might avoid excessively burdensome consumer protections and eschew mandates that would force policyholders to subsidize particular sectors or groups. The problem is that optional federal chartering might achieve few or none of those results and might instead harm competition, safety, and soundness.

Because the need for and terms of insurance coverage are closely linked to substantive state law (for example, workers' compensation and motor vehicle accident reparations law), property-casualty insurance markets have an inherently local dimension. The scope of possible gains from centralization is correspondingly limited. Federal chartering would be unlikely to exempt federally chartered insurers from participation in state residual markets, given legitimate state interests in ensuring the availability of mandatory coverage. State regulation of residual market rates might therefore still be used to cap rates for high-risk buyers and produce chronic cross-subsidies. More broadly, the temptation to use insurance regulation to redistribute wealth need not be lower at the federal level.

Misguided state regulation is largely unable to achieve subsidies across lines of insurance within a state or across states. Federal regulation might be able to achieve both, especially if redistributive policies were mandated for state and federal insurers. For politically sensitive insurance coverage, federal regulation could ultimately lead to restrictions on rates with harmful effects on private-sector risk management and resource allocation. Past examples such as the Home Mortgage Disclosure Act, the Community Reinvestment Act, various consumer group proposals, and recent congressional hearings on sub-prime lending and credit life insurance suggest that federal insurance regulation would be subject to many of the same pressures that produce controls on rates and underwriting in some states.

If most insurers could switch charters at relatively low cost, dual chartering could promote regulatory competition, help discipline regulatory excesses, and provide strong motivation for further state reforms. But, as long as the threat of tighter federal regulation is credible, additional gains from actual competition between state and federal regulators may be modest. Moreover, the largely fixed costs of adopting a federal charter might discourage many smaller insurers from seeking a federal charter, and the cost for multistate, federally chartered insurers to return to state regulation could be large, thereby undermining regulatory competition for charters.

Federal deposit insurance protects depositors of both federal and state banks. A federal guaranty covering the obligations of *all* insurers is likely to be a precondition for effective regulatory competition on other dimensions. The potential benefits from increased regulatory competition should be assessed in relation to the disadvantages of an inclusive federal guaranty program. It is highly probable that federal guarantees of both federally chartered and state-chartered insurers would be inevitable with dual chartering. Even if initial dual chartering legislation eschewed federal guarantees and required federally chartered insurers to participate in state guaranty funds (as in the insurance trade group proposals) or established a federal guaranty system for federal insurers (as in the banking group, LaFalce, and Schumer proposals), predictable political incentives are likely to result in federal guarantees for all insurers.

An optional chartering system that required federally chartered insurers to participate in the state guaranty system without a federal guaranty would be unstable. Insolvency of a federally chartered insurer or a number of state-chartered insurers would create strong pressure for a federal guaranty patterned after deposit insurance. In any event, the state guaranty system would likely be seriously weakened without participation of federally chartered insurers.

The danger is that federal guarantees would repeat some of the mistakes of federal deposit insurance. The scope of protection of insurance buyers against loss from insurer insolvency might be expanded materially (for example, by reflecting a policy, de facto or de jure, of ‘‘too big to fail’’). Such expansion would materially undermine incentives for safety and soundness. More regulatory constraints on insurer operations would eventually ensue. The ultimate result of optional federal chartering would therefore be less reliance on market discipline and more reliance on regulation.

Current proposals for optional federal chartering would eliminate the antitrust exemption for federally chartered insurers, which could undermine the integrity and value of current systems of information sharing and thus reduce competition, increase costs of ratemaking, and reduce safety and soundness, with disproportionate effects on small insurers. Optional federal chartering also would involve protracted litigation over the scope of federal preemption of state insurance law and permissible cooperative practices for federally chartered insurers.

Regulatory policies in some states that interfere with competitive insurance pricing are clearly inefficient; they reduce gross domestic product and consumer welfare. Although optional federal chartering might hasten the demise of such policies, that result is hardly ensured. The unsatisfactory pace of state reforms does not imply that optional federal chartering is desirable.

Conclusion

Despite the obvious shortcomings of regulation of insurance rates and policy forms in some states, optional federal chartering of property-casualty insurers is not in the best interests of policyholders and taxpayers. The possible benefits from optional federal chartering—a reduction in inefficient state rate and form regulation, achievement of regulatory scale economies, and promotion of regulatory competition—are speculative, subject to real uncertainties, and probably modest at best. The potential risks and costs are comparatively large, including modifications in insurance guaranty funds and data-sharing arrangements that would undermine safety, soundness, and healthy competition. Optional federal chartering also could ultimately produce broader restrictions on insurance pricing and underwriting, which would increase cross-subsidies among policyholders, place taxpayers at risk, and inefficiently distort policyholders' incentives to reduce the risk of loss. The better and more prudent policy is to reject federal chartering and encourage and support further modernization of state regulation.

The recent enactment of terrorism insurance legislation notwithstanding, Congress should avoid creating new federal insurance and reinsurance schemes and strive to make existing government programs more efficient. Although politically difficult, it should encourage better risk management by requiring current federal government insurance programs to apply private-sector underwriting and risk classification techniques; increase private-sector risk bearing; and, if necessary, target any remaining premium subsidies more narrowly. Congress should also promote the accumulation of additional private-sector capacity for bearing catastrophic risk. The most direct approach—apart from fundamental tax reform—is to allow private insurers to offer more affordable coverage by allowing them to establish tax-deferred reserves for catastrophic risks.

Suggested Readings

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