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Insurance Regulation in the Public Interest: The Path Towards Solvent, Competitive Markets*

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The rationale underlying competition is that market forces are best at allocating resources and enhancing consumer choice and value. Further, the evolution and internationalization of financial services markets could significantly promote economic development throughout the world. Thus, moves to render national and international insurance markets more competitive should be encouraged, taking into account the level of development of each market and recognizing the necessity for reasonable safeguards to protect the public. In this respect, the World Trade Organization (WTO) Financial Services Agreement marked an important milestone in the evolution toward competitive markets. However, market access alone does not ensure vigorous, fair competition. Regulatory reforms also are needed. The next step toward structuring insurance markets that better serve the interest of each country's citizens is regulatory reform built on a set of pro-competitive principles designed to ensure competitive, solvent, and fair markets. This article offers such a set of principles that are designed to permit national insurance markets to better serve the public interest. These principles are not an argument for elimination of regulation. In fact, pro-competitive regulation requires a greater – not lesser – emphasis on solvency oversight, disclosure and consumer information, and market monitoring. An insurance market structured around these principles will be one in which regulation is adequate, impartial, and minimally intrusive and, importantly, in which the regulatory process is transparent.

1. Introduction

The market-economy model continues to be embraced worldwide by progressive countries. At the same time, improvements in transportation, information, and communication technology have driven the internationalization of financial services. The rationale underlying the competitive model is that market forces are best at allocating resources and enhancing consumer choice and value, thus maximizing overall social welfare. Hence, moves to render markets more competitive should be encouraged, taking into account the level of development of each market and recognizing the necessity for reasonable regulatory safeguards to protect the public interest.

The successful completion of the WTO Financial Services Agreement in December 1997 marked an important milestone in the evolution toward competitive markets. It laid a

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legal foundation for market access in insurance and other financial services. However, market access alone does not ensure vigorous, fair competition. Regulatory reforms also are needed.

Several interrelated policy problems not addressed by the December 1997 Agreement hamper the drive toward more competitive markets:

(1) Diverse national regulation, predicated on the outdated assumption of discrete, insular national economies, hinders global competition in financial services.[1]
(2) Many regulatory practices unnecessarily impede effective market access and tilt the competitive balance in favor of established firms *vis-à-vis* new entrants.
(3) Traditional trade policy principles are insufficient to ameliorate systemic frictions because most are ill suited to address this new generation of regulatory issues.

The new order of global competition has thus revealed problems with existing regulatory and trade policy approaches. This results in imbalances that hinder and distort competition.

The next step toward structuring insurance markets that better serve each country's national interest is regulatory reform built on a set of pro-competitive principles designed to ensure competitive, solvent, and fair markets. This article offers such a set of principles that will move national insurance markets toward the competitive ideal. We do not argue that regulation should be eliminated. In fact, pro-competitive regulation requires a greater – not lesser – regulatory emphasis on solvency oversight, disclosure and consumer information, and market monitoring. As will be seen, regulation based on these principles will be adequate, impartial, minimally intrusive, and transparent.

We lay the foundation for these principles by explaining why a well functioning insurance market is vital to national economic prosperity. We then explore why a competitive insurance market is in each country's best interest, outline where regulation is needed, and examine different regulatory approaches and their implications. The article closes by asserting the set of principles that will lead to competitive, solvent insurance markets that serve each country's interests.

Some readers may perceive the principles we assert to be relatively elementary. However, the world at large is characterized by a wide range of views on the roles of markets and government in insurance and financial services. Greater consensus is needed to support international trade in these services and the evolution of less developed markets. Hence our discussion is targeted particularly for an audience who may not presume the pro-competition principles we discuss. The fact that many countries, including the U.S., have not fully accepted or realized these principles suggests that their discussion is far from moot.

2. Insurance is necessary for economic prosperity

Financial services generally and insurance in particular are of primordial importance to economic development. The more developed and efficient a country's insurance market, the greater will be its contribution to economic prosperity. It is wrong to view insurers as simple

[1] The terms used to refer to insurers domiciled in a regulatory jurisdiction and insurers domiciled outside a regulatory jurisdiction need to be defined. The term "national" refers to insurers domiciled or activities occurring within a country and the term "foreign" refers to insurers domiciled or activities occurring outside a country. Hence our terminology differs from the practice in the United States, where state insurance regulators use the term "foreign" to refer to insurers domiciled in another state, and the term "alien" to refer to insurers domiciled in another country.

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pass-through mechanisms for diversifying risk under which the unfortunate few who suffer losses are indemnified from the funds collected from many policyholders. Laudable though it is, this function is complemented by other fundamental contributions that insurance makes to prosperity. Countries that are best at harnessing these contributions give their citizens and businesses greater economic opportunities. Insurance provides seven categories of services important to economic growth.

2.1 Insurance can promote financial stability

Insurance helps to stabilize the financial situation of individuals, families, and organizations by indemnifying them against many perils. Without insurance, losses could cause individuals and families to become financially destitute and force them to seek assistance from relatives or friends or from the government. Businesses that incur significant uninsured losses may suffer major financial reverses or even fail. In such an event, not only would owners lose their stake in a firm, society would lose the firm's future contribution to the economy. Employees lose jobs, suppliers lose business, consumers are deprived of its products, and government loses tax revenues. The stability provided by insurance encourages individuals and firms to create wealth with the assurance that their resources are protected against the many types of perils that can be insured. Hence, a primary contribution of insurance is its support of risk-taking activities that would not be feasible without it.

2.2 Insurance can substitute for and complement government security programs

Insurance, especially life insurance, can substitute for government security programs. Private insurance also complements public security programs. Thus, it can relieve pressure on social welfare systems, reserving government resources for essential social security and other worthwhile purposes, and allowing individuals to tailor their security arrangements to their own particular needs. Studies have confirmed that greater private expenditures on life insurance are associated with a reduction in government expenditures on social insurance programs (Beenstock, Dickinson and Khajuria, 1986; Wasow, 1986). This substitution role is especially advantageous because of the growing financial challenges faced by national social insurance systems.

2.3 Insurance can facilitate trade and commerce

Many products and services are produced and sold only if adequate insurance is available. Insurance coverage may be a condition for engaging in a particular activity. Because of the high risk of new business failure, venture capitalists often make funds available only if tangible assets and the entrepreneurs' lives are adequately insured. Entrepreneurs are more likely to create and expand their business ventures if they can secure adequate insurance protection. Insurance underpins much of the world's trade, commerce, and entrepreneurial activity.

This fact is unsurprising. Modern economies are built on specialization and its inherent productivity improvements. Greater trade and commercial specialization demand, in turn, greater financial specialization and flexibility. Without a wide range of insurance products and continuing service and pricing innovations, insurance inadequacies could stifle both trade and commerce. Insurance is an essential "lubricant of commerce".

Insurance can play an important role in mobilizing savings. Studies have shown that, on

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average, countries that save more tend to grow faster (IMF, 1995).[2] Insurers channel savings into national investment and enhance financial system efficiency in three ways. First, insurers reduce transaction costs associated with linking savers and borrowers. Insurers congregate and invest the small premiums of numerous insureds as loans to businesses and other ventures. This intermediation avoids the need for direct lending and investing by individual policyholders, which would be time consuming and costly. It is more efficient for insurers to acquire the information necessary to make sound investments, rather than require individuals to acquire the same information. In turn, the efficiencies and higher returns achieved by insurers are passed to policyholders through lower premiums and/or enhanced benefits.

Second, insurers create liquidity. Insurers invest policyholder funds to make long-term loans and other investments. Policyholders, however, have immediate access to loss payments and savings while borrowers need not repay their loans immediately. Alternatively, if all individuals undertook equivalent direct lending, the proportion of their personal wealth held in long-term, illiquid assets would be unacceptably high. Insurers and other financial intermediaries thereby reduce the illiquidity inherent in direct lending.

Third, insurers can reap economies of scale in investment. Many investment projects are quite large, especially in relation to the financial capital available in many emerging markets. Such large projects often enjoy economies of scale, promote specialization, and stimulate technological innovations and therefore can be particularly important to economic development. By amassing large sums from thousands of smaller premium payers, insurers can often meet the financing needs of such large projects, thereby helping the national economy by enlarging the set of feasible investment projects and encouraging economic efficiency. For example, in the U.S., insurers provide financing for fully one-third of all corporate debt.

A well developed financial system will have a myriad of financial institutions and instruments. Other things being the same, the greater the variety of financial institutions and products, the more efficient the system and the greater its contribution to economic development. Contractual savings institutions, such as life insurers and private pension funds, can be especially important financial intermediaries in emerging markets. In contrast with commercial banks, which often specialize in collecting short-term deposits and extending short-term credit, contractual savings institutions usually take a longer-term view. Their longer-term liabilities and stable cash flows are ideal sources of long-term finance for government and business.

2.4 Insurance can enable risk to be managed more efficiently

Financial systems and intermediaries price risk and provide for risk transformation, pooling, and reduction. The better a nation's financial system provides these various risk management services, the greater the saving and investment stimulation and the more efficiently resources are allocated.

Insurance enhances market signals by pricing risk. A competitive market's success depends on appropriate price signals. The pricing of risk is fundamental to all financial intermediaries and is no less important to their resource allocation than to any other supplier of goods or services. Insurers price risk at two levels. First, through their underwriting

[2] Of course, this finding does not suggest that every country with a high savings rate will have a high growth rate. Countries with inefficient financial systems are less likely to achieve high growth rates even with high savings rates.

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activities, insurers evaluate the loss potential of businesses, persons, and property for which they might provide insurance. The greater the expected loss potential, the higher the price. In pricing loss potential, insurers cause insureds to: (1) quantify the consequences of their risk causing and risk-reduction activities; and thus (2) more rationally deal with risk. Investors in projects judged too risky for insurance at any price are put on notice and should rationally expect returns commensurate with the risk. When governments unnecessarily interfere with accurate insurance pricing, their actions may distort the allocation of insurance and, therefore, other resources.

Second, through their investment activities, insurers evaluate the credit quality of those to whom they extend loans and the likely business success of those in whom they invest. Through these activities, business owners, potential investors, customers, creditors, employees, and other stakeholders can be better informed about a firm's overall risk characteristics and thereby make prudent decisions.

Insurance also enables businesses and individuals to transform their risk exposures to better suit their own needs. Many property, liability, loss of income, and other risk exposures can be transferred to an insurer for a price and, in the process, the insured's risk profile changes. Moreover, life insurers, by tailoring contracts to the needs of different clients, help individuals and businesses transform the characteristics of their savings to the liquidity, security, and other risk characteristics desired.

Further, risk-pooling and reduction lie at the heart of insurance and, as with risk-pricing, occur at two levels. First, in aggregating many individual risk exposures, insurers can make reasonably accurate estimates of the pool's future losses. The larger the number of insureds, the more stable and predictable is the insurer's experience. This reduces volatility and objective risk and enables the insurer to charge a smaller risk premium for uncertainty and to stabilize premiums.

Second, insurers also benefit from pooling in their investment activities. In providing funds to a broad range of enterprises, individuals and others, insurers diversify their investment portfolios. The default of a few borrowers is likely to be offset by many sound investments. The more stable and predictable an insurer's investment experience, the less it needs to charge for loans.

2.5 Insurance can encourage loss mitigation

Insurance companies have economic incentives to help insureds prevent and reduce losses. Moreover, their detailed knowledge about loss-causing events, activities, and processes affords them a competitive advantage over many other firms in loss assessment and control. If the pricing or availability of insurance is tied to loss experience and risky behavior, insureds, in turn, have economic incentives to control losses. The advance funding of potential losses through insurance provides the opportunity to properly influence individuals' and firms' behavior to reduce risk.

Insurers support many loss control activities, typical of which are fire prevention, occupational health and safety, industrial loss prevention, reduction in automobile property damage, theft and injury, and many other loss control activities. These activities reduce losses to businesses and individuals and complement insurance and other risk management devices. Society as a whole benefits from this loss reduction.

It is true that insurance can lead to moral hazard. However, insurers can use various pricing mechanisms and policy provisions to mitigate the moral hazard problem. Also, because individuals and firms can often externalize uninsured losses to other parties (which

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creates a moral hazard problem in itself), it can be argued that insurance can often decrease rather than increase moral hazard. This is illustrated in several examples, including lenders' requirements for insurance coverage of the collateral backing loans, compulsory automobile liability insurance, and mandating various forms of liability coverage for firms involved in hazardous activities.

2.6 Insurance can foster efficient capital allocation

Insurers gather substantial information to evaluate firms, projects, and managers both in deciding whether and at what price to issue insurance and in their roles as lenders and investors. While individual savers and investors may not have the time, resources or ability to undertake this information gathering and processing, insurers have an advantage in this regard and are better at allocating financial capital and insurance risk-bearing capacity. Insurers will choose to insure and to provide funds to the most sound and efficient firms, projects and managers.

Insurers have a continuing interest in and monitor the firms, projects and managers to whom they provide financial capital and risk-bearing capacity. They encourage managers and entrepreneurs to act in the best interests of their various stakeholders (customers, stockholders, creditors, etc.). By doing so, insurers tangibly signal the market's approval of promising, well managed firms and foster a more efficient allocation of a country's scarce financial capital and risk-bearing capacity. National financial systems that minimize constraints on insurers' abilities to gather and evaluate information in this way should realize a more efficient allocation of capital and therefore stronger economic growth.

3. A competitive insurance market is in the national interest

Competitive insurance markets are in the national interest. This view continues to be embraced worldwide, although several governments seem tentative, facially endorsing it while retaining elements of restrictive regulatory systems. Many governments continue to deny their citizens and businesses access to low priced, high quality insurance policies and services. These actions suggest that (1) regulation exists more to protect established private interests than the overall national interest; or (2) policy-makers remain skeptical that competitive markets will deliver the benefits to the national economy suggested above. We analyse both issues below.

3.1 Different regulatory approaches reflect different interests

Government intervention into insurance markets takes many forms, some direct, some indirect. Its stated purposes are always noble: to protect consumers, to raise revenue to support worthwhile social objectives, or to ensure orderly, well functioning markets. However, in reality, regulation does not always serve noble purposes.

Various factors influence regulatory policies and behavior. These factors include market problems that regulators are seeking to rectify, ideology, special interests, and regulatory resources. The goal of regulation should be to protect consumers and to promote the public interest. This objective is achieved by appropriate government measures designed to address significant market difficulties (see below) which, in turn, aids market efficiency. Our recommendations are based on this theory of the role of regulation.

Other factors sometime distort regulation in ways that do not serve the public interest.

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Often, private organizations or certain groups exert undue influence on regulation to serve their interests at the expense of consumers and the overall national welfare (Peltzman, 1976). For example, established insurers might support regulation that bars entry and diminishes competition from new insurers, both national and foreign. The resulting regulatory restrictions might be cloaked in the guise of "consumer protection", but consumers are actually hurt by such restrictions. Special interest groups typically are better informed, financed and organized than consumers generally and, hence, can exert a disproportionately high level of influence on regulators.

Regulation unduly influenced by such special interests is characterized by:

(1) Restrictions on entry of new national and especially foreign insurers;
(2) Suppression of price and product competition; and
(3) Control of inter-industry competition from those selling similar or complementary products.

Insurance regulation that exhibits these characteristics is subject to "capture" by the local industry, with the result that both individual and commercial insureds are penalized through high prices, lack of product innovation, and poor product choice. It is obvious that private interests sometimes take precedent over the greater national good. Citizens and businesses, through dedicated government representatives and through publicity, must be ever vigilant in exposing such abuses of the public trust and should support measures that expose and thwart such abuses. The glaring light of truth, coupled with transparency in all relevant government decisions and processes, provides the strongest and most effective means of preventing and detecting abuses.

3.2 Competition enhances choice and value

Some policy-makers seem skeptical about the benefits of competition. However, the objective that a market-oriented economy has for its insurance industry is the same as that which it has for other industries – an efficient allocation of society's scarce resources as it maximizes consumer choice and value. Furthermore, society desires an economic system that leads to continuous innovation and improvement. These objectives are most likely to be achieved through reliance on competitive markets.

Competition not only leads to economic efficiency, it provides an automatic mechanism for creating a greater variety of choices and fulfilling consumer needs and wants. Additionally, competition compels insurers to improve their products and services, thus further benefiting buyers. In the absence of significant imperfections, a competitive market requires no government direction or oversight to accomplish these desirable social goals.

Perfect competition is an ideal that cannot be realized, but a market can be *workably competitive*, which means that it functions reasonably well and provides most of the benefits of competition (Scherer and Ross, 1990). Markets characterized by workable competition generally have low entry and exit barriers, a sufficient number of buyers and sellers, good information, governmental transparency, and the absence of artificial restrictions on competition. Many industries satisfy these conditions sufficiently so that little regulation is required to achieve an efficient allocation of resources. Markets in some industries, such as banking and insurance, suffer from market *imperfections* or *failures* that require regulatory oversight in specific areas to ensure healthy competition and good performance.

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3.3 Competition has limitations

All markets have imperfections, but they are generally not significant enough to warrant government intervention. However, in instances where market imperfections are significant, government intervention might be needed to protect consumers and promote workable competition. In insurance, the justification for regulatory intervention stems primarily from the existence of information problems and principal–agent conflicts, and occasionally from excessive market power. Sometimes insurance market problems are not inherent to the industry, but are caused by government policies.

The efficiency of government intervention to address a particular market imperfection must be evaluated from a cost–benefit standpoint. Is the market imperfection so severe that the benefits of a specific government intervention outweigh its costs, direct and indirect?[3]

A critically important assumption of the competitive model is that both buyers and sellers are well informed. As a practical matter, we know otherwise. Information problems abound in insurance, and arguably are the industry's most important market imperfection (Joskow, 1973; Schlesinger, 1998).

Insurance is a complex business, with buyers having superior information to sellers in certain instances (e.g. buyers have better information about their relative risk when they apply for insurance) and vice versa in others (e.g. the insurer knows more about its financial condition than does the buyer).[4] *Asymmetric information problems* exist when one party to a transaction has relevant information that the other does not have.

Insurance contracts promise future performance upon the occurrence of stipulated events. Individuals and businesses purchase policies in good faith, relying on the integrity of the insurance company and its representatives. Even assuming that insureds could be induced to take an interest in the financial condition of their insurers, few are sufficiently knowledgeable to do so without some assistance.[5] Insurance is necessarily a technical, complicated subject, and the true financial condition of an insurance company can be determined only by expert examination. Also, some individuals may have difficulty understanding the complex nature of insurance contracts. These statements are less applicable for sophisticated buyers, such as large businesses, than for persons.

Information problems for insurance customers provide the rationale for the great majority of insurance regulation. Insurers and their representatives have little incentive to

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[3] This notion is embodied in economists' definition of "workable competition". A market is considered to be workably competitive, when its conditions reasonably approximate those of perfect competition and government intervention cannot increase social welfare (Scherer and Ross, 1990). Further, the emphasis is on entry and exit barriers, competitive behavior and efficient market performance, rather than the number and size of firms and product homogeneity. This definition, broadly interpreted, could be consistent with a variety of market structures, including structures where there is extensive product differentiation or only a few major sellers, i.e. the "theory of contestable markets" (Baumol, Panzar and Willig, 1982). However, these alternative structures do not assume that firms possess significant market power, which can serve to promote or undermine the public interest. We discuss the implications of this distinction below.

[4] This may be the less the case with certain personal insurance purchases, such as automobile insurance. Insurers' access to and use of large databases and actuarial methods may give them an edge in assessing an insured's risk. At the same time, insureds may posses certain information about their risk characteristics (e.g. their compliance with traffic laws) that the insurer can only surmise from the insured's history, provided that the insured does not change his or her behavior. Hence, the balance of information between insurer and insured can vary depending on the specific circumstances.

[5] Admittedly, consumers' incentives to take an interest in insurers' financial strength can be diminished by the existence of insolvency guaranty funds or other mechanisms that assume the obligations of failed insurers.

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disclose adverse information to potential customers. Doing so hurts sales. Governments seek to rectify the unequal positions between insurance buyer and seller by mandating certain disclosures for insurers, by monitoring insurers' financial condition, by regulating insurers' marketing practices, and through other means.[6] Because insurance is a financial future-delivery product tied closely to the public interest, governments judge this information imbalance between buyers and sellers to warrant substantial oversight of the financial condition of insurers. The widely accepted view is that the public, especially poorly informed consumers, must be protected.

In many aspects of insurance processes, neither the buyer nor the seller has complete information because the desired information simply does not exist. Insurers cannot know the future. Environmental factors – such as the economy, inflation, new laws and regulations, and changing consumer attitudes and preferences – present great uncertainty to both insurance buyers and sellers. Government measures sometimes can help to reduce uncertainty.

Asymmetric information and other factors can lead to *principal–agent problems* in insurance markets. Such problems arise, for instance, when policyholders have difficulty in monitoring and controlling the behavior of their insurer. The insurer might incur additional financial risk that is hazardous to its policyholders' interests or fail to meet its obligations to policyholders. If the insurer becomes insolvent or refuses to pay claims, policyholders may find it very costly or impossible to recover funds or force the insurer to fulfill its obligations. Unequal resources and bargaining power between the insurer and an individual policyholder can exacerbate the problem. It is true that principal–agent conflicts can arise in many contractual and other business relationships. However, the fiduciary roles played by financial institutions, including insurers, and the differences in resources between firms and individuals, present a particular problem.[7]

Because of these problems and other market imperfections, private insurers will not supply every type of insurance that consumers demand. Insurers may perceive excessive adverse selection or moral hazard problems or they may be unable to diversify their loss exposures. Thus, the private insurance mechanism generally offers little unemployment insurance and faces some difficulty in insuring catastrophic events such as earthquakes and nuclear disasters that could cause huge, concentrated losses in a particular area. In each instance, insurers perceive too much uncertainty occasioned by a change in the state of nature or state of the world, coupled with prospects for severe adverse selection. In such instances, the government may need to provide insurance or facilitate broader risk-pooling by private insurers.

Information problems also may prevent individuals from acting in their own best interests. One of the premises for social insurance programs is that individuals will not or cannot fully arrange for their own financial security, so government must do it for them. Arguably, elements of social security programs could be privatized over time for individuals with sufficient financial resources to provide for their own security through the purchase of appropriate insurance and financial products. Government programs could be targeted more to low-income individuals who lack such resources.

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[6] Another way government may address this problem is by providing consumer information and education. Private for-profit and non-profit organizations also can provide consumer information and education, but government may play a valuable role in this area as well.

[7] The vulnerability of third parties and the negative externalities that could be caused by an insurer's failure to fulfill its contractual obligations is another argument for some regulation.

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Insurers also can acquire market power, under some circumstances, which permits them to limit competition. Market power is the ability of one or a few sellers (or buyers) to influence the price of a product or service. Under the competitive model, sellers and buyers are price-takers – meaning that they are so small compared with their market that they cannot exercise any meaningful influence over the price and quantity of a good or service, either individually or collectively. However, if some players in the market can affect price and quantity significantly to serve their interests, the allocation of resources generally will be inefficient.

In most cases, in the absence of government restrictions, insurance markets are structurally competitive (Cummins and Weiss, 1991; Klein, 1995). Entry and exit barriers and economies of scale and scope are not of a nature that would allow a small number of insurers to acquire meaningful market power. Even in highly concentrated markets, the ever-present threat of new entry can impose competitive discipline, i.e. the concept of "contestable markets" (Baumol, Panzar and Willig, 1982).[8] If insurers enjoy meaningful market power within a country, the cause usually can be traced to restrictive government control over entry and competition. The solution in such instances is not more regulation, but rather the removal of the government restrictions on entry and competition.

Several countries have monopolistic markets (e.g. Iran and India), and many others are oligopolistic (e.g. Japan and South Korea), because of government policies. Explicit or implicit collusion historically has been common in many insurance markets internationally, especially concerning pricing. Tariff markets, in which all sellers charge similar or identical prices, remain common in many developing countries and for certain insurance lines in some OECD countries.

National tax regimes can create market power. Some countries assess higher premium taxes on the local business of foreign insurers than they do on the local business of national insurers. Such practices are analogous to trade tariffs and have similar adverse economic consequences.

Market power in insurance arises also from structural impediments to entry. Examples include the Japanese *keiretsu* system, extensive cross-share holdings within Germany, and the lack of broker or other independent distribution systems within several markets.

National licensing requirements technically are entry barriers, although they are justified on consumer protection grounds. Some entry restrictions are appropriate to ensure that insurers are financially sound and their owners and managers are honest and competent. However, some governments go beyond this legitimate objective and will refuse a new license in the absence of a recognized market need. Other countries will not grant new licenses under any circumstances or require local equity participation. Transparency in the licensing process is less than desired in many markets, with numerous unwritten rules.

Entry and exit barriers are minimal in the insurance markets of the OECD countries, but reasonable freedom of entry does not exist in many of the world's insurance markets. Several countries prohibit or severely limit the creation of new national insurers, and many erect substantial entry barriers to foreign insurers, although the trend is toward more liberal

[8] It could be argued that highly concentrated markets with large firms may offer certain advantages, such as a greater ability to invest in research and innovation. Whether this is true for insurance is a matter of debate. Regardless, the theory of contestable markets implies that even concentrated markets may be competitive if there is a continuing threat of entry. However, if firms possess significant market power because of entry barriers, then the negative consequences must be balanced against any perceived benefits. Further, this requires consideration of the need for regulation to harness firms' market power in the public interest.

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markets. Ultimately, consumers should be the judges of whether an insurer responds to their needs, not government.

3.4 Insurance regulation should rectify market imperfections

Other imperfections exist in insurance markets, but the above are the most obvious and common. Government's role in crafting insurance regulation should be limited to rectifying imperfections that can cause significant harm. A pro-competitive approach, therefore, would warrant governmental intervention into the insurance market only with respect to matters that meet three conditions:

(1) An actual or potential market imperfection exists;
(2) The market imperfection causes, or can reasonably be believed to cause, meaningful consumer or public harm; and
(3) Government action can ameliorate the harm.

Conversely, if any one of the three conditions is not met, government intervention is unwarranted. Thus, government intervention is not justified with respect to any insurer operation that does not cause demonstrable or reasonably expected harm. Even if some aspect of insurer operations might adversely affect some individuals, intervention is unwarranted if the intervention would be ineffectual or might actually exacerbate the problem. Just as there is no perfectly competitive market, so too is there no perfect government regulation.

All existing and proposed insurance regulations should be tested against these three conditions. Some existing and proposed regulations will meet all three conditions. Others will not and should be abandoned.

The likelihood of consumer abuse because of market imperfections will vary from country to country. Thus countries with a long history of competitive insurance markets will have already resolved many of the complex issues concerning appropriate government intervention. Countries moving from monopolistic and other restrictive regimes, on the other hand, must exercise a certain degree of caution to ensure that abusive practices do not undermine confidence in a embryonic competitive insurance market and consumers are sufficiently informed to protect their own interests.

Justifiable government intervention should be minimally intrusive and as efficient as possible. For example, one way to minimize consumer harm occasioned by insurer insolvencies is to allow insurers to collude to set prices so high that even the most inefficiently operated insurer is guaranteed a profit and, therefore, survival. Such an approach, however, results in high priced insurance and excessive profits (and/or excessive waste) for insurers, all at the expense of consumers and businesses and, therefore, at the expense of the national interest. The superior approach is to allow price competition, bolstered by reasonable capital standards and close monitoring of insurers' financial condition. This approach yields lower insurance prices, thus benefiting the national economy, while minimizing the possibility of consumer harm that would otherwise arise from excessive insurer financial risk and insolvencies.

4. Insurance regulatory approaches vary greatly

Private insurance cannot flourish without public confidence that it will function as promised. Government's duty is to ensure that this confidence is neither misplaced nor undermined. Consequently, every country has insurance laws and regulations to determine who may sell and underwrite insurance and the circumstances under which they may continue

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to do so. Countries usually establish minimum reserve, asset quality and quantity, and capital requirements. In many countries, regulators also control prices and policy provisions.

Governments regulate insurance purchased by individuals more stringently than insurance purchased by businesses and other organizations because of the greater information problems for individuals. Reinsurance historically has been subject to minimal regulatory oversight because both buyers and sellers are usually well informed.[9]

Insurance products and services are provided through government entities in some countries. Historically, these countries believed that government insurance programs were the best way to achieve social goals for protection against risk. In most of these nations, government insurance was a natural consequence of socialist economies in which most businesses were owned by the state.

4.1 Three variations of regulatory systems

It is possible to distinguish three fundamental types of government intervention in insurance. One approach emphasizes competitive markets and minimal intrusion with respect to market forces and insurers' decisions. Chile, and to a lesser extent the U.S., are examples of this approach.

The second approach relies on more restrictive regulation of market forces and the partial or complete sheltering of private insurers from competition. Historically, Japan, Korea, some European countries, and developing countries fell into this category. Of course, the situation has since changed dramatically in the E.U. countries, with Japan and Korea also relaxing key aspects of regulation. Other countries have made less progress.

Countries that delegate the provision of insurance to the government fall into the third category. Most such countries (for example, China and India) are moving toward a role for private insurance providers, although other countries have yet to make meaningful progress.

Each of these systems faces a particular set of issues in restructuring markets and regulatory systems to be more competitive in the national interest. Obviously, those countries that heretofore have had the greatest degree of government involvement in their insurance markets have the farthest to tread in moving towards the competitive model. Yet changes are occurring and an orderly progression toward a market-guided insurance industry is achievable even where insurance is currently subject to intensive government control. Below we discuss Chile's experience as an example of how significant market and regulatory transformations can be achieved.

4.2 Transformation in Chile

Chile offers a particularly interesting case study because of the great transformation that it has undergone over the last two decades. For this reason, it exemplifies the movement from intensive government involvement to a market-based approach to insurance services.[10] Our

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[9] It is possible to protect consumers' interests through indirect or secondary regulation of reinsurance transactions. For example, in the U.S., regulators protect consumers' interests by setting standards governing ceding insurers' ability to claim accounting credit for reinsurance transactions.

[10] See Skipper and Klein (1999) for a review of the insurance markets and regulatory systems in other selected countries.

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focus is on the deregulation and liberalization process in Chile, rather than on the structure and performance of its market.

The first authorized Chilean insurance company and the oldest in Latin America is "La Chilena". It was not until 1927, however, that a statute established the government's regulatory and intervention powers with respect to insurance. This law also created a central reinsurance fund. A 1931 decree allowed a more protected system, with insurance trade reserved to Chilean majority ownership companies. It authorized the Superintendency of Insurance to approve tariffs, agents and reinsurance commissions, as well as the required companies' investments to cover their net worth and technical reserves. The decree also instituted a 60 per cent tax on contracts placed with unlicensed insurance companies. The 1931 decree forbade the operation of any company exclusively dealing with reinsurance, excepting the reinsurance fund, thus establishing a state reinsurance monopoly.

At that time, additional laws established compulsory insurance through state institutions in the areas of collective transportation liability, automobile liability insurance (also offered by private companies), export credit insurance, as well as other miscellaneous lines. The decree, these additional laws and some 1970 amendments remained the basis for insurance regulation and policy in Chile until 1980.

The deregulation of the Chilean insurance market was part of a comprehensive restructuring program. This program differed dramatically from that followed by other Latin American countries at the time. Other countries continued to rely on a substantial state role with private national competitors largely sheltered from meaningful competition.

Among the macro-economic reforms in Chile were the privatization of most state-owned firms, a reduction of trade barriers, liberalization of prices, deregulation of capital markets, liberalization of interest rates, reform of land and labor markets, and revision of tax law, together with a conservative fiscal budget. Chile's famous pension privatization program was adopted in 1980, the same year that its insurance laws were amended.

The new legislation was oriented principally at promoting competition and protecting insureds. The basic issues covered were:

(1) Freedom of tariffs;
(2) The end of the state reinsurance monopoly;
(3) Freedom of brokers' commissions;
(4) The establishment of a supervisory system based on solvency, requiring a foundation capital of 60,000 Developing Units (UF), equivalent to about US$1.3 million at that time;
(5) Restrictions on investments backing technical reserves;
(6) The indexation of premiums, claims, and insured amounts by their being expressed in UFs or in foreign currency;
(7) Freedom of establishment by foreign insurers and reinsurers; and
(8) Transparency of the market.

Amendments to the law in the late 1980s and in 1994, (1) increased the minimum capital requirements for creation of a new insurer to UF90,000 (about US$2.8 million in 1996 dollars) and established new minimums for already established insurers, relying on leverage and net worth ratios; (2) required investment diversification by type of security and economic groups; and (3) authorized insurers to invest up to 15 per cent of their investments in securities issued in foreign countries.

The changes had a profound effect on the insurance regulatory function in Chile. The office of the Superintendency of Insurance was completely reorganized and substantial

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changes in personnel instituted. In particular, far greater financial and personnel resources were dedicated to the review of insurance companies' financial statements and other regulatory activities. The quality of regulatory personnel was upgraded, especially in the technical areas. In addition, the regulator's office, in effect, educated many insurers about the importance of establishing accurate financial information in general, and technical reserves in particular.

From the insurers' point of view, the changes forced them to adopt new ways of thinking about their operations and the insurance business. The new rules required a profound administrative rationalization. More highly qualified personnel were engaged, particularly more technical personnel in order to be competitive in a new open market. Insurers also had to meet the higher capitalization requirements, thus giving rise to several mergers of smaller insurers.

The reinsurance fund lost its monopoly position, as several national and foreign-owned reinsurers established a market presence. The results are said to have been successful, despite initial skepticism related to a possible major outflow of foreign exchange reserves.

Evaluations of the new law suggest that initial capital requirements were perhaps too low and requirements for investment diversification inadequate. It is believed that more rigorous requirements in 1980 would have minimized damage to the sector during the financial crisis that affected the whole Chilean economy in 1982–1984. In addition, although the new financial and human resources assigned to the Superintendency were significant, many observers contend that they were insufficient to allow the quality of regulatory oversight that should have followed such massive reform.

The Chilean deregulation and liberalization brought new levels of competition to the market, dramatically lowering insurance prices. The many new competitors, mostly foreign, brought more sophisticated technology and innovative products, reinforcing the overall development of the insurance industry.

Chile today has a vibrant, competitive insurance market offering a wide range of products at competitive prices. Foreign-owned insurers and intermediaries play a major role in the market, but many national insurers also have prospered in the new environment. Based on the experience of countries such as Chile and the concepts of competition and regulation presented above, we now articulate a set of principles that should guide the movement toward competitive insurance markets.

5. The path towards competitive, solvent insurance markets

In today's globally competitive financial services world, the nature and specific features of each government's intervention into its market should be reassessed to ensure that every aspect is essential and is accomplishing its goal at minimum market disruption. The most common rationale for government intervention into insurance markets is to protect buyers – in economic terms, to rectify market imperfections. To do this, insurance regulation should seek to ensure that *quality, reasonably priced* products are *available* from *reliable* insurers.

A well structured competitive market will ensure that the *quality, reasonable pricing* and *availability* goals are attained. Hence an important role of government is to promote fair competition to achieve these goals, while protecting buyers from misleading, collusive, and other anti-competitive practices. At the same time, arguably the most important governmental role is to ensure that insurers are *reliable*.

To promote the twin goals of having a competitive *and* solvent insurance market, insurance regulation should have the following traits:

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(1) Adequacy;
(2) Impartiality;
(3) Minimal intrusiveness;
(4) Transparency.

Each area is addressed below, with appropriate pro-competitive principles offered. These principles can serve as the basis for building competitive insurance markets that serve consumers' interests and promote a vibrant economy.

5.1 Regulation should be adequate

Regulation should be adequate, meaning that it should be sufficient to rectify meaningful market imperfections and thereby protect the public. Several principles of adequacy follow.

To establish an adequate system of regulation, governments must first have necessary laws and regulations in place that create the framework for a competitive market. Our first principle, therefore, is that:

> Governments should enact and enforce laws that provide an effective framework for competitive insurance markets

Anti-trust (competition) law is a vital component of this framework. Such law regulates the nature of competition in the marketplace rather than individual competitors. As markets move from restrictive to liberal regulatory approaches, competition law becomes more important as some firms will have motives to try to engage in anti-competitive practices. The law should give regulators clear and strong authority to prevent or punish individual and collective behavior that lessens competition, such as monopolization, predation, collusive price-setting, market-sharing arrangements, and other anti-competitive actions.

In developing these as well as the other laws and regulations suggested herein, governments should consult with all interested parties, including insurance companies, insurance intermediaries and buyers. These consultations will help ensure that laws and regulations are adequate, impartial and minimally intrusive – in other words, they will help ensure fair, competitive markets that operate for the benefit of the country's citizens. Transparency is fundamental to the entire regulatory process, as discussed below.

Such laws and regulations also should address all relevant aspects of insurer operations, from creation to liquidation. The most essential component relates to *prudential regulation*, which brings us to the next principle related to adequacy of regulation:

> Governments should enact and enforce laws that establish reasonable solvency standards and regulation as the primary means of protecting the public

The more competitive a market, the more important is prudential regulation. The insurance regulator in a deregulated market faces more complex and difficult issues than his or her counterpart in a strictly regulated market. Indeed, prudential regulation can be deceptively simple in tariff markets in which all insurers charge the same or similar prices such that the least efficient insurer can enjoy reasonable profitability. Insolvencies in such markets are diminished by overcharging.

Not all insolvencies can or should be prevented. In a competitive market, some insolvencies are inevitable. Government's delicate task is to minimize consumer harm occasioned by such difficulties, but without signaling other insurers that mismanagement or

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other unsound business practices will be tolerated. This calls for rigorous but fair enforcement of well crafted prudential regulation.

The emphasis of prudential regulation should be to prevent insurers from incurring excessive levels of financial risk and timely intervention when an insurer's financial condition becomes hazardous. This can be accomplished by reasonable minimum financial standards and effective monitoring of insurers' financial condition.[11] Such a strategy should include frequent informal consultations with insurer executives to keep regulators well informed about potentially adverse developments and enable them to steer insurers away from actions that would threaten their policyholders' interests. Effective implementation of this approach should keep insolvency costs at an acceptable minimum.

Resolving the problems of financial difficulties for existing insurers should be a priority. Thus, our next principle would lead to the creation of appropriate and consistent ways of dealing with insurers that incur financial difficulties:

> As a part of reasonable solvency regulation, governments should establish, make public, and enforce appropriate and consistent rules and procedures for identifying and dealing with financially troubled insurers

An objective of insurance regulation should be to establish proper incentives for efficient and safe insurer operation and institute safeguards to keep the number of insurer insolvencies to an acceptable minimum. A marketplace with no insurance failures likely is one in which insurance is expensive and consumer choice limited.

Government's responsibility is to establish rules and procedures for identifying and for dealing with financially troubled insurers. A key element in the identification process is the establishment of appropriate accounting, reporting, and auditing standards and requirements. Governments would be wise to borrow freely from international best practices standards.

The rules and procedures for dealing with troubled insurers should be sufficient to address the particular difficulty and should be consistently applied across all competitors. Regulators need broad authority, as well as flexibility, but they must use this authority judiciously and be accountable to the public. The rules and procedures should be made public and any changes subject to transparent regulatory processes (see below).

After identifying an insurer as financially troubled through surveillance mechanisms, regulators have four options:

(1) Informal actions;
(2) Formal actions;
(3) Rehabilitation;
(4) Liquidation.

In each case, the question policy-makers address is what authority should the regulator have compared to the regulated. Regulatory action taken precipitously might needlessly harm insurers, ensuring their demise because of adverse publicity. Delayed regulatory action can lead to greater consumer loss. In some instances, regulators may be able to employ informal or formal actions, short of seizing control of an insurer, that will adequately remedy the insurer's problems. In other cases, limited action may be insufficient, and regulatory seizure of a

[11] Some form of risk-based capital standard or prudential solvency margin is essential to an effective financial regulatory program.

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troubled insurer is necessary. The regulatory problem is to determine an appropriate and consistent intervention strategy given the circumstances surrounding the insurer, the information available, and the constraints present at the time regulators must make a decision. Regulators should be subject to periodic review by independent government auditors to ensure that they have acted appropriately.

The next step to ensure adequate regulation in a competitive market involves creating an independent regulatory agency with sufficient resources to enforce laws and regulations efficiently, effectively and impartially:

> Governments should establish an insurance regulatory agency that operates in the national interest and has sufficient resources to efficiently, effectively and impartially enforce the nation's insurance laws and regulations

If the agency is to function in *society's* interests, as opposed to *private* interests, it should operate independently of undue insurance industry and other special interest influence. It is insufficient that the regulatory body be established as an agency of the government. The means by which industry input is secured also must be transparent, impartial and consistent. Rules may be necessary to limit undue influence over regulatory decisions, such as not allowing former heads of the regulatory agency to lobby the agency for a certain period of time after vacating the office. Due process and transparency (see below) are critically important to ensuring that the regulator deals at arms' length with the regulated.

The regulatory body must be provided with sufficient financial and other *resources*, including information technology, to carry out its regulatory function. The quality and integrity of supervisory personnel is a critical resource issue. Regulation in competitive markets is more complex and difficult than regulation in restrictive markets. Because of this fact, more competent, highly skilled, and technical employees are required for effective regulation in a competitive market.

Regulatory *effectiveness* means that responsibilities are carried out in ways that genuinely ameliorate the identified market imperfection. Regulatory *efficiency* means that responsibilities are carried out expeditiously, with prudent use of the agency's resources, and with minimal intrusion and cost burdens on insurers (see below). Regulatory *impartiality* means that responsibilities are carried out with fairness to all market participants and without favoritism toward any. Impartiality is of such great importance that it warrants separate treatment (see below).

Observers correctly note that insurance regulatory oversight in many emerging market-economy countries may not be sufficiently attuned to protecting consumers in a liberalized, competitive market. They may need to enhance prudential supervision, competition regulation and market conduct regulation as they deregulate and liberalize their insurance markets, as the experience of several Latin American countries attests. At the same time, the movement from a restrictive to a competitive market does not take place overnight, which brings us to our next principle:

> Governments should develop and implement pro-competitive insurance regulation in a way and at a pace that ensures adequate protection of the public but that proceeds without undue delay and is subject to a reasonable implementation timetable

Certainly, new insurer entry into and operations in formerly restrictive markets should not be allowed to overwhelm government's ability to protect consumers and the stability of the national insurance industry. On the other hand, experience suggests that consumer protection

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concerns are often asserted as a justification for unreasonable delays in liberalizing and deregulating. Policy-makers should recognize that entrenched interests will always urge slowness in reform. Yet the road to reform should be traveled at the maximum possible safe speed, not the minimum. Moreover, reform should follow a reasoned, carefully crafted route, which means that an implementation timetable, with clear deadlines, is essential. This reduces uncertainty about future regulatory policies and encourages insurers to make long-term investments in establishing and enhancing their operations.

5.2 Regulation should be impartial

The principle of *impartiality* is fundamental to a competitive market. It means that governments should accord no competitor or group of competitors more favorable treatment than that extended to other competitors or groups of competitors, thus, our next pro-competitive regulatory principle is that:

> Governments should ensure that insurance regulation and enforcement are applied with consistency and impartiality between competitors, irrespective of the nationality

Historically, the fair trade principle of *national treatment* has been the standard for impartiality and, in minimally intrusive regulatory regimes, this standard is a reasonable test of impartiality. The principle requires governments to enact and administer national laws and regulations such that foreign producers, products, and services are accorded treatment no less favorable than that accorded national producers in similar circumstances. It is intended to ensure equality of competitive opportunity for foreign entrants.

National treatment problems exist for foreign insurers in some markets. Thus some countries have different deposit or capital requirements for foreign insurers than for national insurers. Many countries assess higher taxes on foreign than on national insurers. Some countries deny or restrict foreign insurer membership in local trade associations, thus denying them equivalent access to national statistics, research, and lobbying services.

A lack of impartiality can take on more subtle forms. For example, countries that strictly regulate product prices and policy forms and that prohibit the use of certain distribution techniques (e.g. independent agents, brokers, or direct response) may not be violating a strict interpretation of the national treatment standard, but their actions constitute hindrances to new entrants. Other government actions that can distort the competitive balance include exchange controls, deposit and lending rate ceilings, privileged access to credit, and unnecessarily strict controls with respect to investments and business powers. Such strict regulation affords already established firms a competitive advantage over new entrants.

National treatment barriers to market access also exist when government restricts the number of competitors within its market and whenever restrictive government regulation accords existing (usually mostly national) firms a substantial competitive advantage over potential entrants. Thus, for example, the E.U. asserted that its bancassurance firms were barred from fully exploiting their competitive advantage in the U.S. market because former U.S. law prohibited such firms from the production and marketing of both insurance and banking services. Similarly, the U.S. complained that rigid Japanese insurance regulation prohibited U.S. insurers from fully exploiting their competitive advantage within the Japanese market.

It is for this reason that many observers support regulatory convergence internationally. Short of achieving this ambitious goal, governments that adopt and implement the minimally intrusive principle will find fewer national treatment difficulties.

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5.3 Regulation should be minimally intrusive

As noted above, all insurance regulation should be based on the goal of rectifying meaningful market imperfections, that is, to protect the public interest. A government will have multiple ways of rectifying each imperfection that it identifies. All of the ways might meet the adequacy test in the sense that they are sufficient to accomplish the purpose. However, some means will prove far more disruptive to the competitive market than others. In selecting among its many alternatives, governments should select those that accomplish the purpose at minimal disruption to the smooth functioning of their insurance markets. Thus an important pro-competitive principle is that:

> Insurance regulation should be limited to that which is: (1) justified as providing meaningful protection; and (2) minimally intrusive to accomplish its purpose

Government should thus avoid any regulatory intervention with respect to transactions and matters that have little or no possibility of harm to the public. Moreover, in selecting among alternative regulatory approaches to address problems that involve the possibility of meaningful public harm, government should always opt for those approaches that solve the problems with minimal interference in, or imposition on, insurance transactions.

This philosophy implies that insurers should be allowed to offer an array of insurance products at prices that they deem appropriate, without being subject to severe restrictions or a cumbersome pre-approval process. Market forces will prevent insurers from sustaining prices above a competitive level. Insurers that charge inadequate prices or incur excessive financial risk can be removed from the market.[12] Products that do not serve consumer needs also will not be viable. Through effective monitoring and targeted actions, regulators can move against insurers that attempt to defraud consumers or treat them unfairly. The threat of timely regulatory enforcement actions and appropriate penalties will help to discourage insurers and intermediaries from engaging in abusive practices. This approach directs regulatory resources towards the small number of insurers and intermediaries who treat consumers unfairly, without subjecting all market participants to unnecessary constraints or burdensome oversight.

An important element of the minimally intrusive principle is government undertaking actions that can increase corporate accountability but without government itself being responsible for all details of oversight. Thus, requiring audits and certifications by independent actuaries and accountants can both relieve government of these tasks and create positive incentives for insurers. Placing more responsibility on management and boards of directors can have similar effects.

It must be stressed that the standard of minimal intrusion does not imply a policy of laissez faire or no regulatory oversight. Rather, it implies that regulation should be confined to interventions that are truly needed and can meaningfully benefit consumers. Effective regulatory monitoring can help to ensure that regulators are alerted to problems that require action on a timely basis.

In determining appropriate regulatory restrictions, policy-makers and regulators must

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[12] Some might argue that insurance price regulation is needed to control cyclical pricing in property-liability insurance, i.e. the "underwriting cycle". However, studies indicate that price regulation does not mitigate cyclical pricing and, indeed, may even exacerbate it (see Cummins, Harrington and Klein, 1991).

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consider the frequency and severity of market abuses or problems. It is not feasible to prevent consumers from ever making a poor choice. In designing regulatory policies, government should focus on areas where there is a pattern of abuse or practices harmful to consumers, reflecting fundamental gaps in consumers' ability to protect themselves.

Restrictive markets usually adopt a philosophy that insurers may do only that which is expressly authorized. Regulation tends to rely on an *ex ante* system of detailed oversight and approval. Such regulation can ensure a stable market, but such markets are rarely innovative, typically offer high-priced insurance, and provide comparatively limited consumer choice and value. Thus, consistent with the minimally intrusive standard, the next principle is:

> Subject only to that regulatory oversight essential to protect the public, governments should allow the market to determine: (1) what financial services products should be developed and sold; (2) the methods by which they are to be sold; and (3) the prices at which they will be sold

Deregulation connotes a lessening of national regulation with the goal of retaining only that which is adequate and minimally intrusive. The most critical first step along the path toward reasoned deregulation is to adopt the philosophy that insurers should have the flexibility to respond to consumer needs in ways that *they* deem appropriate, subject, of course, to regulatory oversight to deal with solvency matters and to minimize misleading or abusive practices. Market forces will encourage insurers to develop and sell products on terms that are in the best interest of consumers.

This philosophy argues for greater reliance on an *ex post* system of oversight wherever it is most efficient. *Ex ante* regulation will remain appropriate for some areas, such as insurer licensing and solvency oversight, where certain market imperfections are best addressed by imposing minimum standards and prohibiting activities that could harm consumers. These will include situations where lack of information and unequal bargaining power between consumers and insurers can lead to abuses that can and should be prevented by regulators.

Many countries have shifted more to *ex post* regulation. Even so, remnants of earlier restrictive approaches persist, if not strictly *de jure* then at least *de facto.* The product approval process in many countries is at best sluggish and at worst erratic, arbitrary and opaque. The benefits of competition are blunted when regulation is slow, unpredictable, or inconsistent. Prior approval of rates and policy forms and other restrictive approval approaches tend to retard adjustment of prices and product innovation. Such actions should be unnecessary in a competitively structured market.

A competitive insurance market will have numerous channels for insurance distribution. New products and services require channels attuned to the buyer's needs and wishes. Brokers and other marketing intermediaries can help insurance buyers make better informed decisions. Government-imposed limitations on distribution channels that could serve the market more efficiently are inconsistent with a market-driven regulatory philosophy. They are examples of governmentally created barriers to entry.

When a government moves from a restrictive regulatory system to greater reliance on competition, some consumer protection functions shift from the government to consumers themselves. Government should ensure that insurance buyers understand that such a fundamental shift has taken place. Buyers will need to become more active in evaluating insurers and their products. Government should ensure that customers have access to sufficient information to be able to make good purchase decisions and protect their own interests. This brings us to our next principle:

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> Governments should ensure that insurance customers have access to information sufficient to enable them to make informed, independent judgements as to: (1) an insurer's financial condition; and (2) the benefits and value of its products

This principle goes directly to the information asymmetry problems discussed earlier in this paper. Regulation may be necessary to compel insurers to make certain disclosures in connection with their sales efforts. In other instances, it may prove most efficient and effective for government itself to be the source of needed unbiased information. This approach will require additional governmental efforts to facilitate informed and prudent customer choices.

Rating agencies and other independent information sources can greatly assist customers as a source of unbiased information. Unfortunately, some governments discourage or prohibit entry by rating agencies and other such independent financial service information firms. Such actions hinder competition in the national interest by denying local businesses and citizens information beneficial to their decisions regarding the purchase and maintenance of insurance and other financial service products.

5.4 The regulatory process should be transparent

Transparency in the regulatory process is fundamental to ensuring a competitive market. This brings us to one of the most important pro-competitive principles:

> Governments should make existing insurance laws and regulations easily available to the public, including to consumers and businesses and to insurers and other financial services providers

The fair trade principle of transparency requires that regulatory and other legal requirements regarding market access and national operation should be clearly and fully set out and easily available. Transparency problems are too common in insurance markets. Many governments' laws and regulations are incompletely set out and not readily available. Foreign firms, in particular, encounter transparency problems in countries that grant their insurance regulatory authorities broad discretionary powers, as the foreign insurer may have no clear understanding of the market access or operational requirements.

Many countries, especially those that have historically been relatively closed, may have unclear or non-existent due process. In such instances, foreign (and national) insurers may not fully understand either their rights to appeal regulatory decisions or the process by which an appeal is launched.

Another dimension of the transparency principle applies to proposed laws and regulations. This dimension requires that all interested parties have the opportunity to know about and to comment on proposed regulations and that methods to challenge regulatory decisions be available.

> In crafting proposed insurance laws and regulations, governments should: (1) make such proposals easily available to the public, including to consumers and businesses and to insurers and other financial service providers; (2) invite comment on the proposals; (3) allow sufficient time for interested parties to provide comment; (4) provide justifications for decisions to accept and reject comments; and (5) establish and communicate a fair process by which decisions considered arbitrary or unjust can be challenged

Although impressive gains in transparency have been made in many markets, others

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continue to draw criticism internationally in this area. Close relationships between government and established insurers are inconsistent with the ideal of transparency. Transparency implies that regulators maintain an "arms'-length" relationship with all insurers and that some insurers do not gain an unfair advantage through privileged associations with regulators.

6. Conclusions

An efficient, competitive insurance market does not evolve overnight from a restrictive one. All market players, including regulators and institutions, need some time to adjust to a changed environment. Entry is costly, even with fewer entry barriers and a more transparent system. New insurers will enter a market gradually as they perceive profitable opportunities and establish a reputation among consumers. At the same time, the danger exists that government could move too slowly or fail to take all critical measures necessary to support effective competition and to protect consumers.

Deregulation and liberalization require the implementation of a reasoned, careful strategy containing all necessary regulatory elements. Objectives must be clear and benchmarks established that will move the market towards competition that serves the public interest. Overall regulation will be less intrusive but it will also be more intense and selective. This fact will demand more highly qualified regulatory officials and staff, especially in the technical areas. Sound research to support informed public policy decisions will become more important in investigating key public policy issues and in measuring market structure and performance.

The internationalization of financial services promises to continue. This new order of global business has revealed gaps in existing regulatory and trade policy approaches. The result is competitive imbalances that hinder and distort global competition. Simultaneously, these new realities can result in greater consumer exploitation and fraud if regulators fail to make appropriate adjustments. The policy issue is how to continue to promote competition through liberalization while ensuring adequate consumer protection.

Divergent national regulatory approaches caused fewer difficulties when financial services markets were insulated from each other and largely national in character. For the future, however, regulatory diversity can impede the continued internationalization of financial services. As has been discussed elsewhere, such diversity might: (1) magnify the negative effects of market imperfections; (2) provoke more stringent national trade-related regulation; and (3) increase transactional costs.[13]

Many observers believe that regulatory harmonization is necessary. Others note the great complexities in achieving even minimal regulatory harmonization. We believe that regulatory convergence is inevitable and in each country's national interest. We remain skeptical, however, about attempts to achieve complete and *de jure* harmonization at this time. The existing level of economic knowledge coupled with considerations argue for a market-driven approach to regulatory convergence that builds on a set of regulatory principles such as those developed here.

Such a *de facto* approach would find like-minded nations agreeing to a set of agreed-

[13] See H. D. Skipper, Jr., "Regulatory Harmonization and Mutual Recognition in Insurance", in H.D. Skipper, Jr., *International Risk and Insurance: An Environmental–Managerial Approach*. Boston: Irwin McGraw-Hill, 1998, ch. 14.

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upon regulatory principles. In agreeing on such principles, governments would focus on "what" should be regulated, not on "how" it should be done, thereby permitting a high level of generality. This approach creates a positive environment for further multilateral negotiations by reducing conflict. If more rapid regulatory convergence seemed appropriate in the future, the principles could form the basis for deeper harmonization.

Some observers express concern about the competitive model, given the economic turmoil being experienced in several countries. Competition itself did not cause the difficulties. Rather, the lack of certain government rules and policies inhibited truly transparent, competitive markets, making a bad situation much worse. It has been argued that greater market access and involvement by foreign financial services firms would have lessened the adverse economic effects. The lesson for governments is to craft laws and enforce regulations that promote more transparent markets supported by fair competition unfettered by government direction, favoritism, and unwarranted interference.

Competitive insurance markets serve each country's interest. Governments that deny their citizens and businesses such markets lessen consumer choice and value, and needlessly hinder national economic development.

We have offered a set of pro-competitive principles that can form the basis for the creation of competitive insurance markets in the public interest. The details of implementation can be expected to vary from market to market to address each country's particular circumstances. However, if the implementation details are consistent with the principles, governments will have unleashed the great power of the market for the benefit of their citizens and their economies.

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