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Efficient Regulation of the Insurance Industry to Cope With Global Trends of Deregulation and Liberalisation

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Abstract
This paper offers a framework for establishing the efficient regulation of the insurance business by reviewing common ways of regulating the industry, in the face of international demands for deregulation and liberalisation.

Keywords
insurance industry, regulation, global deregulation, liberalisation, international commerce

EFFICIENT REGULATION OF THE INSURANCE INDUSTRY TO COPE WITH GLOBAL TRENDS OF DEREGULATION AND LIBERALISATION

*By Eun Sup Lee**

Introduction

Since the adoption of GATT there has been a worldwide trend towards deregulation and reliance upon market forces to provide regulatory restraint and efficiency, with intervention occurring only after the fact. Although most nations are responding to both international external pressures to deregulate and liberalise their financial industries by relaxing their regulations, regulation remains a major factor in the insurance industry. Complementary policy measures are desperately needed to minimise the negative effects that may arise from relaxing regulations and opening markets. Such reforms also play an important role in protecting consumers' interests and strengthening the competitiveness of the industry. The primary targets of regulation are insurers, producers, claims representatives, and perhaps other service providers, such as licensors, with regulations based upon financial condition or knowledge level, as indicated by the passing of written examinations.

Specific insurance regulatory activities are divided into two primary categories: solvency regulation and market regulation. Solvency regulation seeks to protect policyholders against the risk that insurers will not be able to meet their financial obligations. Market regulations, which attempt to ensure fair and reasonable insurance prices and products, must be coordinated to achieve their specific objectives. Regulation of rates and market practices affects the insurers' financial performance, while solvency regulations constrain the prices and products that insurers can reasonably offer.[1]

Thus, the general areas of regulation of the insurance industry include permission to establish an insurance business, permission to open an agent's business or a brokerage business, approval of insurance products and premiums, control of

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1 Robert W Klein, 'Insurance Regulation in Transition' (1995) 62 *The Journal of Risk and Insurance,* 369.

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unauthorised insurance business and unfair trade, examination of an insurer's financial status, and rehabilitation of an insurance business. Insurance regulation can be classified into several categories, including ex-ante regulation, ex-post regulation, or combinations thereof. Under the ex-post regulation system, the government intervenes in the market only after regulations are violated, in a remedial or after-the-fact involvement. The ex-ante regulation system focuses on prevention of illegal activities by proscribing or regulating them before-the-fact.

When a government is actively intervening in the market, the insurance industry will be controlled by the ex-ante system; therefore the more the insurance industry is exposed to market principles, the less it is subject to ex-ante regulation.[2] The policy measures should strive to tighten regulations on faltering insurers with respect to financial status, relax regulations on the sound insurers, and lower entrance barriers to foreign insurers. This paper offers a framework for establishing the efficient regulation of the insurance business by reviewing common ways of regulating the industry, in the face of international demands for deregulation and liberalisation.

Licensing of the Business

Since governments are authorised to license the insurance industry, new insurance providers are thoroughly screened for financial soundness prior to their entry into the market as the most fundamental means of protecting the public.

The following factors are generally considered in the decision to issue a licence: licence requirements, organisational structure of the insurers, ownership restrictions, restrictions on doing non-insurance business, separation of lines of the business, and right of appeal.

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2 According to Harold D Skipper Jr, Robert W Klein, and Martin F Grade: 'In theory, government policymakers should use ex-ante regulation to prevent harm if the cost of prevention is less than the harm caused by a failure to take preventive action. The optimal regulatory response should examine the costs and benefits of both approaches and select that which is the more effective. Thus market economies typically adopt both models, using in each instance whichever model yields the greater net benefits. For example, in most countries, tort law is, in effect, ex-post regulation, because it is too costly to determine rights prior to an accident. Health and safety regulation on the other hand, is thought to be less expensively implemented before actual harm is shown to workers. This is especially true when the likelihood of employee compensation is related to the employer's ability to pay for the harm caused.' Harold D Skipper Jr PhD, Martin F Grace, Robert W Klein, 'Alternative Approaches to Insurance Regulation: An International Comparison', paper presented at the conference held by the Financial Supervisory Board of Korea (1997) 84.

Licensing Requirements

The minimum requirements for an insurer's financial standing should be decided in the context of other public businesses. Over-tightened requirements may restrain the consumers' choice of insurers by blocking market entry and thereby free competition, while over-loosened requirements may endanger the consumers by allowing financially and ethically unsound insurance companies to enter the market.[3] Except for the special case of commercial insurance, for example reinsurance[4], direct insurance can be sold only by authorised insurers in most countries.[5]

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3 Solicitor Toby Blyth indicated the complexity in establishing the minimum solvency margin requirement relating to Australia's 'bare minimum' framework as follows: The minimum solvency margin requirement serves two purpose, that is, providing for a high probability of maintaining solvency, and allowing for a possibility of the solvency to be deteriorated from time to time. However, solvency itself carries a 'cost' to the insurer, equal to the price paid by shareholders and eventually policyholders. Requirements that may assist policyholders are not necessarily beneficial to the (short-term) goals of the company/shareholder wanting to maximise profit/return on equity. Although an insurer will always desire to maintain greater reserves than what is required, the 'cost' of parking money in required reserves represents an upper level barrier for the insurer, and can have a negative effect on profit/return on equity. Minimum capital requirements may increase tax liability, and consequently, the premiums to generate a fair return to shareholders. In addition to the costs to insurers and their shareholders in maintaining the minimum statutory solvency requirements, negative shocks to industry capital and the subsequent capital adjustment costs inevitably lead to price hikes by the insurer to avoid the possibility of failing to meet the regulatory minimum and a declaration of 'ruin'.

In evaluating the current Australia's 'bare minimum' solvency margin regulation, Blyth also pointed out that even though the current regime might allow too much flexibility and leeway to insurers to chart their own courses, any form of further solvency regulation would be a form of state-sponsored protection of shareholders' funds instead of protection against the 'insolvency' of an insurer for insured claims.

Toby Blyth, 'The Regulation of Capital Adequacy in the Australian Insurance Market: Theory and Practice' (2000) 11 *Insurance Law Journal* 114 - 115.

4 In the US, for example, unauthorised insurance business is allowed to some extent in the excess and surplus lines markets. An insurer licensed in one state maybe allowed to do the business in other states when an intended insurance is not available through professional agents in the authorised markets. The white list (a list insurers allowed to do the business without permission) and the black list (a list of insurers mot allowed to do the business without permission) are used to regulate the insurance business. However, an insurer on the white list is not automatically allowed to do business without permission in every state, because some states do not allow unauthorised insurance business in any case.

5 Most African countries, and most North and Latin American countries, such as Brazil, Colombia, Venezuela, Mexico, and the US, prohibit non-admitted insurance. China, India, Japan, South Korea, the Philippines, Taiwan, Thailand and most other Asian countries similarly restrict their sale and purchase, with important exceptions being Hong Kong, Malaysia and Singapore. Skipper et al, above n 2, 89.

The minimum financial requirement prescribed by the government[6] should be satisfied for an insurer to obtain a licence for the insurance business.[7] One of the criteria for evaluating financial status is the prescribed minimum capital, or, in the case of mutual insurers, the initial fund. These funds are to be used as the minimum paid-in capital or the initial working capital, which is greater than the minimum paid-in capital.[8] Most countries demand a minimum level of personnel quality in the insurance business. In the U.K., the professional quality of management is emphasised, as indicated by the slogan 'good people make for good

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6 In Australia, for example, the following requirements apply to insurers: where the applicant is incorporated in Australia, the value of its assets must exceed the amount of its liability by not less than: (a) $2 million; (b) 20 per cent of its premium income during the financial year last preceding the financial year in which the application is made; or (c) 15 percent of outstanding claims provisions at the end of the financial year last preceding the financial year in which the application is made, whichever is greatest. Where the applicant is incorporated overseas, both (a) and (b) apply. The only difference is (c), where 15 percent of outstanding claims provision with respect to liabilities in Australia at the end of the financial year last preceding the financial year in which the application is made.

However, should a potential insurer meet these requirements, the Australian Prudential Regulation Authority(APRA) may decide not to grant authority and the Treasury will determine whether the authority should be granted or refused. Blyth, above n 3, 112-113.

7 In granting a license for an insurance business, even though some developing countries still discriminate against foreign insurers vis-a-vis domestic insurers, the current trend is for countries to adopt the national or most-favoured-nations treatment in the spirit of the Uruguay Round Agreement on Trade-Related Services. For example, Article II-1 of the Agreement states 'With respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country,' and Article XVII-1 states '...each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.' It is usually required for foreign insurers seeking admission into a market to prove that they are lawfully organised and licensed in their home jurisdiction. Several countries, such as Australia, Canada, Denmark, Finland, Iceland, Japan, South Korea, Norway, Spain, and Switzerland and Taiwan, and several US states admit foreign insurers only if they have operated successfully in another jurisdiction for a specified time, often three to five years. Skipper et al, above n 2, 91-92.

8 In the United States, traditional fixed minimum capital and surplus standards, which typically range from US $500, 000 to US $8 million for a multiline insurer, are more appropriate for start-up operations than for established companies with significant premium volume and risk exposure. Because insurers range widely in the size and type of risk they assume, fixed minimum capital standards are inadequate for many. In practice, regulators can and do take action against troubled insurers before they fall below the minimum standard, but such action are subject to legal challenges, and regulators must convince a court that an insurer is in an unsafe condition. Klein, above n 1, 370.

companies.'[9] In general, for permission to enter the insurance business, an insurer must submit a proposed business operation plan, which is evaluated for soundness by the authorities concerned.[10] In addition, in many states, the insurers must inform the insured of their intention to withdraw from the business in advance, pay processing fees, and submit a plan to reimburse unpaid insured amounts and other debts. Such measures are to prevent market turbulence caused by insurers pursuing short-term profits.

Organisation Forms and Ownership Restrictions

Stock and mutual corporations are the most common forms of insurance companies. Additionally, the organisation may take the form of unincorporated mutuals, fraternal benefit societies, cooperative insurers, Lloyd's associations, reciprocals, nonprofit service plans, or health maintenance organisations.[11]

Such organisational forms may vary according to the insurance laws of each country. Lloyd's association is permitted only in the UK. Most countries that permit foreign insurers to enter into their markets apply national treatment principles with respect to organisational forms.

Under the principles of the market economy, the government does not restrict the ownership of an insurance company unless the insurance is subject to national security policy or other public policy, such as social welfare policy. However, in some developing countries, foreign nationals are not allowed to wholly own an insurance company; a minimum share of the ownership must be maintained by the nationals. Such measures prevent the consumers from enjoying the product innovations and low prices propelled by free competition. Most countries have allowed mutual ownership between bankers and insurers, while the US and Japan have not.[12]

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9 Skipper et al, above n 2, 90.

10 Some countries (eg, Germany, Switzerland, etc) employ a very rigorous application process, while others (eg, the US) are generous in their evaluation process.

11 In the United Kingdom, a company or association consisting of more than 20 members and carrying on insurance business must have been constituted in one of the following ways: 1) Incorporated by charter; 2) Incorporated by special Act of Parliament; 3) Unincorporated but authorised by letters patent under the Chartered Companies Act 1837; 4) Formed before 1844 as a common law partnership or mutual association and formally registered under section 58 of the Act of that year; 5) Formed between July 14, 1856 and August 25, 1857 as a common law partnership or association; 6) Formed under the Act of 1844 and re-registered under the Companies Act 1862; 7) Formed as a friendly society and registered under the Friendly Societies Acts; 8) Formed as a trade union; 9) Formed after 1862 under one of the Companies Acts. Nicholas Legh-Jones et al, *MacGillivray on Insurance Law* (1997), 927.

12 However, the US is moving toward deregulation of such restrictions, which in turn raises concerns about fair competition and the possibility of transferring the banker's potential insolvency to the insurance company (and vice versa). Skipper et al, above n 2, 94. Recently, Japan liberalised the method used to establish financial holding

Finally, while in most countries an insurance company may not own non-insurance companies, in some cases, an insurance company may be authorised to own, as a holding company, a non-insurance company on condition that safeguards are observed.

Restriction of the Combined Management of Life and Property Insurance Businesses

Composite insurance, which combines both life and non-life insurance, has its economic basis in the common and fundamental functions of insurance, such as risk transfer, risk diversification, and financial intermediation. Most of the European countries, except for the Scandinavian countries, have adopted the composite insurer system,[13] while the United States, Japan, Korea, and most of the developing countries have not.[14] Under this system, in which multiple insurance businesses may be run concurrently, the insurer must issue separate accounting reports, positing assets, debts, and capital for each of the combined insurance businesses.

The reasons for such restrictions on composite insurers are two-fold: to achieve regulatory simplicity in controlling the insurance business, and to prevent the transfer of financial risk among the insurance businesses. In most countries, both life and property insurance companies are allowed to run health insurance businesses and to combine the management of direct insurance and reinsurance.[15]

Right to Appeal

In most industrialised countries, applicants meeting all of the requirements for an insurance business may appeal for re-examination if the license is denied. The appeal case may be filed with a court (the United States, Finland, Germany,

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companies by passing the Financial Laws to Cope with the Lifting of the Ban on the Establishment of Holding companies, Eun Sup Lee and Choong-Lyong Ha, 'Regulation of Korea's Insurance Industry under the IMF Program' (2000) 31 *Journal of Risk Management* (Japan Risk Management Society), 217.

13 With respect to this matter, historically the most difficult problem which had to be resolved in the negotiations leading to the EC directives in 1979 (No 7912671 EEC of March 5, 1979, D.J.L63/1) was the existence of composite life and non-life insurance in the United Kingdom, while the majority of EC states required that that life insurance be provided only by 'specialist' life insurance companies not involved in any other class of business. The outcome was that no new 'compositors' could be authorised in the United Kingdom. Existing 'compositors' could continue and could set up branches or agencies in other EC states for non-life business. If, however, they wished to conduct life business elsewhere in the community, they were required to set up subsidiaries. Legh-Jones et al, above n 11, 927.

14 Skipper et al, above n 2, 95.

15 Most reinsurance worldwide is conducted through specialty insurance. Skipper et al, above n 2, 95.

Switzerland, etc), an administrative tribunal (Australia), or the government ministry (Japan).[16]

Solvency Regulation

The government supervises an insurance company by monitoring its financial soundness[17] and by requiring the company to maintain its qualifications as an insurance business. In general, tightening the regulations concerning financial soundness influences the security of the insurance business in a positive way,[18] while over-regulation may impair the consumers' interests by obstructing free competition and innovation. Therefore, the supervising authority should properly harmonise these contradicting forces.

As the insurance market becomes liberalised and more competitive, it becomes more important for the government to control and regulate the credibility of insurers. In other words, as the insurance business is liberalised, it becomes more difficult to supervise the insurers with respect to their financial standing. Efficient regulatory methods for these circumstances are examined in this section.

Financial Requirements

The most important factor to be considered in evaluating the availability of coverage is the relative net worth of an insurer or the amount of capital. The amount of capital is defined as excess of assets over liabilities.[19] Therefore, to estimate the capital of an insurance company, the values of both assets and debts must be properly evaluated.

Based on such factors as surplus funds, premium revenues, insurance amounts, and liability reserve funds, a minimum level of ongoing capital and surplus to be reserved, called the 'solvency margin,' is imposed on insurers in many countries, including those of the EU. The EU directive[20] establishes the minimum solvency

16 Ibid 95.

17 Regu Most reinsurance worldwide is conducted through specialty insurance. Skipper et al, above n 2, 95.

19 For instance, the insurers in France, Switzerland, Germany and Japan, where insurers have been strictly regulated on their availability of coverage, have rarely experienced financial difficulties, compared to other countries. Skipper et al, above n 2, 96.

19 Surplus funds of insurers, capital and surplus funds, policyholder surplus funds, and shareholder funds denote the same meaning as capital in evaluation.

20 The EU directive has been the main tool to standardise the basic regulations of the insurance business among the 15 EU member countries. The EU directive, as an ordinance established by the EU's Council of Ministers, demands that members observe the EU directives when amending existing laws or enacting new laws. The EU directive has played an important role in unifying the insurance markets of the EU.

margin.[21] Some Latin American countries also have already adopted the 'minimum solvency margin' system as one of the efforts to prevent insolvency in insurance companies.[22]

In the United States, the Insurance Law of each state[23] requires that new applicants for the insurance business maintain a level of capital above or equal to that of sound, existing insurance companies. Such a uniformly fixed amount of capital invested in an insurance company does not have a direct relation to the total debts to the policyholders, investment, or other risks. In addition, the regulating authorities employ unofficial standards, including premiums, to surplus ratios in order to assess the financial standings of insurance companies. The US regulatory authorities currently employ Risk-Based Capital (RBC) standards,[24] which contrast the minimum acceptable capital with the size and

21 The EC directive on freedom of establishment (No 73/239 of July 23, 1973, OJ W 2283) introduced a uniform system of solvency margins calculated as a percentage of annual premiums on claims (whichever gave the higher result) and prescribed a procedure to be followed in the event that an insurer failed to show possession of the necessary margin. For example, the minimum capital of a non-life insurance company should be at least equal to 18 percent of the written premium (adjusted for reinsurance) or 26 percent of the average net claims paid for the preceding 3 to 7 year period (adjusted for reinsurance), whichever is greater. This means that the financial resources of an insurance company should increase as the scale of business grows. Cited in Legh-Jones et al, above n 11, 928; Skipper et al, above n 2, 97.

22 Skipper et al, above n 2, 97.

23 In the United States, a debate has been waging since the passage of the McCarra-Ferguson Act in 1945 on whether regulation at the federal level would be more effective than state regulation. With passage of the Act, each state was granted the authority to regulate the insurance industry in its jurisdiction. Each of the 50 states, the District of Colombia and the four territories of the US has its own insurance department, with actuaries, accountants, and insurance examiners among its employees. The states' insurance departments are continually involved with regulatory development and insurer financial reviews. An insurance company must be authorised by the state insurance department before it may conduct business there.
These licensing requirements include satisfying the minimum capital and surplus requirements for all the lines of business an insurer wishes to sell in that jurisdiction. On an ongoing basis, the insurer must comply with the rate-making and financial reporting law of that state. Thus, a company operating in more than one state must keep up with the special laws of each particular state. For the uniformity of regulation in the United States, the National Association of Insurance Companies (NAIC) has been actively involved in model legislation, most recently in investment practice and risk-based capital requirements. Subsequently, as states adopt these statutes the United States is becoming more uniform in its regulation in spite of the lack of federal regulation. See Gean Lemaire and Krupa Subramanian, *Insurance Regulation in Europe and the United States* (1997) 34-35.

24 As the Risk-Based Capital Act for life and health insurance companies was passed in 1992 and in 1993, respectively, and a similar law was passed for property-liability insurance companies, NAIC introduced the RBC system to clearly evaluate the appropriateness of capital levels of insurance companies. The life-health RBC formula

riskiness of a company's underwriting (technical) and investment (non-technical) operations.

Financial Reports

The imposition and performance of the reporting liability play key roles in controlling the insurance companies' availability of coverage. In most countries, all insurance businesses are required to submit detailed financial statements including balance sheets, income statements, and prescribed notes and exhibits.

In the EU, balance sheet and income statement are prepared with the same format by all of the member countries, and the insurers submit annual reports of business performance.[25] In the United States, the insurers submit to the supervising authorities detailed quarterly and yearly financial reports together with a CPA's assessment of the audit and an accountant's confirmation of reserve funds.[26]

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covers four major categories of risk: asset risk, insurance risk, interest rate risk and business risk. Asset risk represents the risk of default and decline in the market value of an insurer's investments. Insurance risk arises from the possibility that premiums and revenues may not be enough to make benefit payments. Interest rate risk arises because fluctuations in rates may adversely affect the insurer's asset values. Business risk incorporates other risks, arising from the operation of an insurer, that are not covered by the other three categories. The property-liability RBC formula encompasses asset risk, credit risk, underwriting risk and off-balance sheet risk. Credit risk involves the risk that receivables (agents' balances and uncollectable reinsurance) will not be paid. Underwriting risk represents pricing and reserve risks, while off-balance sheet risk incorporates other risks such as excessive growth. The NAIC method employs the Authorised Control Level (ACL) of capital that is necessary for an insurance company to cover the internal risks of assets and liabilities. The riskier each factor is, the larger ACL becomes. To decide its relevance, ACL is compared with Total Adjusted Capital (TAC), which refers to the legal capital adjusted for voluntary reserve and other surplus. Regulation authorities are authorised to take specific actions if an insurance company's TAC falls below a certain specified percentage of its RBC. Insurance companies with over 200% (TAC/ACL) are not under the special regulation. However, those with rates between 150% and 200% must submit the RBC proposal specifying an improvement plan to the state government where their headquarters are located. Those with rates between 100% and 150% not only submit the RBC plan but also, after examination or analysis by the regulating authorities, are ordered to follow the authorities' directions to improve the rates. The authorities have the legal grounds to rehabilitate or liquidate the company, if an insurer's capital falls between 70% and 100%. The authorities should take the enforced measures for those with the rates below 70%. See Lemaire and Subramanian, ibid 46-47.

25 Skipper et al, above n 2, 105-106.

26 Insurance companies in the United States must prepare annual financial statements on both a GAAP basis and a SAP basis, which differ in degrees of conservatism. GAAP derives its name from generally accepted accounting principles, those guidelines which have been accepted by the major professional groups that define and regulate accounting transactions. Financial statements based on statutory accounting principles

Superintendence of Financial Status

After the supervising authorities grant permission for an insurance company to operate its business and establish a financial report system, they should continuously monitor whether the insurance company maintains the minimum reserve funds to secure and reimburse insurance claims. The superintendence of reserve funds is conducted through the following three mechanisms:

a) financial analysis using the reported information;
b) financial examinations conducted periodically (eg, very 3 to 5 years) or on a case-by-case basis;
c) oversight by the profession.

When the above mentioned mechanisms indicate that an insurance company is experiencing financial difficulties (ie, inability to reimburse), the supervising authority intervenes through formal measures, informal measures, rehabilitation, or liquidation.[27] However, hasty regulatory actions may unnecessarily restrict the insurance business or impair its credibility, while delayed regulatory actions may harm insurance consumers.[28] Among the informal regulatory measures are cordial acquisition and merger. The formal regulatory measures include ex-ante approval for a particular transaction, discontinuance or limitation of new business, capital increase, and discon tinuance of a particular business.

When an insurance company fails to comply with the recommendations or orders of the supervising authority, some OECD countries alert the general public by publishing the corrective measures in newspapers or magazines. In some countries, the regulating authority may dismiss the management staff of an insurance company, and may suspend or rescind the operating licence when an insurance company is in serious financial trouble;[29] these measures would be subject to court review.

(SAP) are required by state laws or regulatory authorities, who use this information in solvency monitoring. Lemaire and Subramania, above n 23, 37-38.

27 Skipper et al, above n 2, 109.

28 Although the nature of the appropriate regulatory action for a troubled insurer varies depending on the circumstances, the essential purpose is to prevent or minimise loss and to provide protection for policyholders. Klein, above n 1, 373.

29 In the United States, when an insurer is considered to be in severe financial distress, the state insurance department has the authority to intervene in company operations. Depending on the degree of financial distress, regulators may try to prevent the troubled insurer from becoming insolvent. There are two levels of regulatory actions with respect to troubled companies: actions to prevent a financially troubled insurer from becoming insolvent and delinquency proceedings against an insurer for the purpose of conserving, rehabilitating, reorganising, or liquidating the insurer. Actions within the first category include hearings/conferences, corrective plans, restrictions on activities, notices of impairment, cease and desist orders, and supervision. Some

When an insurance company is liquidated, the insured usually have priority over other claimants. Among the insured, those with life or other liability insurance receive the highest priority for reimbursement.

Protective Measures for Insolvency

Most countries have a system to guarantee payment against insured claims (eg, insolvency guarantee associations or funds). One of the main reasons to introduce guaranty funds is imperfect policyholder information.[30] The insurance company

actions against insurers may be confidential and others may be publicly announced. Sales or mergers of troubled insurers are often negotiated by regulators to avoid market disruptions. Many troubled insurers which have been subject to regulatory action are never publicly identified because their problems are resolved before more drastic action is required. However, if preventive regulatory actions are too late or otherwise unsuccessful and an insurer becomes severely impaired or insolvent, then formal delinquency proceedings will be instituted. These measures can encompass conservation, seizure of assets, rehabilitation, liquidation, and dissolution. For many insurers, these actions are progressive. A regulation may first seek to conserve and rehabilitate a company to maintain availability of coverage and avoid adverse effects on policyholders and claimants, as well as lower insolvency costs. However, the regulator may ultimately be forced to liquidate and dissolve the company if rehabilitation is not feasible. Regulators typically need court approval for such actions, which may be challenged by the troubled insurer. Typically, there are two guarantee funds in each state, one for property - liability policies - and one for life-health. Except in New York, these funds work on a post-insolvency assessment basis. In the event of an assessment, companies are assessed an amount in proportion to the amount of premiums they collect in a particular line of business. In New York, companies pay an annual premium into the state insurance fund which is available to fund liabilities to policyholders. Robert W Klein, above n 1, 373-374; Lemaire and Subramanian, above n 23, 48.

30 In the United States, the information for the policyholders as well as for the insurance companies is provided by private organisations that evaluate insurers according to specific criteria of stability and translate those judgements into letter ratings, corresponding to certain levels of financial strength. The prominent insurance rating service in the United States is the AM Best Company, founded in 1940. Best complies data from statutory annual statements for both property-liability and life-health insurance companies. Best assigns a rating based on the following five factors: underwriting performance, management economy, reserve adequacy, adequacy of net resources, and soundness of investments. Their evaluation is based on comparison of an insurer's financial information with Best's benchmarks. After this financial review, a company receives a letter grade, anywhere from A++ to F, which corresponds to a valuation ranging from excellent to fair to poor. Best requires at least five years of financial data to determine a rating, the rationale being that one year's financial conditions are important, but how the company progresses from year to year is equally important. Other prominent rating bureaus in the United States include Standard & Poor's Insurance Rating Services, Moody's Investors Service, Duff & Phelps Credit Rating Company, and Weiss Ratings, all of which also use letter ratings. Lemaire and Subramanian, above n 23, 49-50.

concerned may be sufficiently indemnified within a general limit (the United States)[31] or may take apportioned responsibility for a loss (United Kingdom).[32] The government (some EU countries)[33] or the insurance business association (the United States, Canada) takes charge of or mobilises such insolvency guarantee funds.[34] Such guarantee funds enhance consumers' credibility regarding the insurance business by providing insolvency protection,[35] though they may weaken the market principle and increase risks in the area of business ethics.[36]

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31 In the United States, state guaranty associations exist to protect policyholders, claimants, and beneficiaries against financial losses due to insurer insolvencies. Fundamentally, the purpose of an insolvency guaranty law/association is to cover an insolvent insurer's financial obligations, within statutory limits, to policy owners, annuitants, beneficiaries, and third-party claimants. Most states limit coverage of property-liability claims and death benefits to US $300,000. Health insurance claims and cash values on life insurance-polices and annuities are typically limited to US $100,000. There are no limits on workers compensation claims. Klein, above n 1, 374.

32 In the United Kingdom, the Policyholders Protection Act, enacted in 1975, provides a system of compensation for policyholders of failed insurers. In the case of property casualty policies, the protection of the policyholders is 100% guaranteed where the insurance cover is compulsory. Other general insurance claims are protected to the extent of 90%, provided the insured is a private policyholder. For the life business, the Board is required to protect at the 90% level policyholders whose claims have crystallised prior to liquidation. In other cases, the Board must first attempt to secure continuity of the policies so that 90% of the future benefit is protected. If this is not possible, policyholders are entitled to receive a sum equal to 90% of the policy value. Lemaire and Subramanian, above n 23, 56.

33 In the United Kingdom, under the Policyholders Protection Act of 1975, the guaranty fund is administrated by an independent Policyholders Protection Board, whose members include insurance industry and consumer representatives. The Board is empowered to raise levies on all British insurance companies, including UK branches of insurers with their head offices in other European states. Lemaire and Subramanian, above n 23 at 56.

34 Skipper, et al, above n 2, 114.

35 It is indicated that, while the guaranty fund concept is designed to provide claimants with some measure of protection against the costs of insurer insolvency, it theoretically has the potential to increase, indirectly, the incidence of insolvency. The reason is that an unfortunate consequence of the post-assessment/flat premium method of funding is the creation of a moral hazard. Feldhaus and Kazenski, see below n 36

36 William R Feldhaus and Paul M Kazanski have pointed out that state insurance guaranty funds in the United States have been criticised for the following reasons: 1) Moral hazard: A common criticism of the current guaranty fund system is that it creates a moral hazard by providing incentives for some insurers to increase their risk-taking behaviour at the expense of more conservative competitors; 2) Capacity: A critical concern is the ability of the state guaranty funds to cope with a substantial failure, due to the insolvency of either a single major insurer or a significant number of regional insurers within a short period of time. Given that each state has a maximum assessment limit, it is possible for a state to reach or exceed its capacity in any year; 3) Lack of uniformity: A common concern with state of the states. Critics of the state guaranty fund system note differences in such areas as lines of business covered, limits of protection, cost-sharing features, net worth limitations, assessment and recoupment

Regulation of the Market

Insurance premium rates and products are regulated by the state in order to clarify the information issued by the companies and to guarantee the insurer's solvency.[37] In other words, the regulating authority should require not only a minimum of premiums to prevent internal market disturbance caused by premium competition that may result in insolvency of an insurance company, but also a maximum to prevent unfairly high premiums resulting from restricted market competition. In addition, owing to the unequal bargaining power between the insurance company and the customers, especially in the case of personal insurance, the insured may be treated unfairly by the insurance company. In such a case, it is necessary to regulate unfair transactions in the insurance market. Finally, the regulating authority may express a preference for regulatory policies to guarantee certain market outcomes consistent with social norms or objectives.[38]

Rates and Policy Forms

Many developing countries maintain tariff markets from which authorised cartels or government rate-setting organs establish insurance rates, acceptable ranges for rates, or permissible factors used to make rate estimations. Advisory organisations, transformed from the tariff market, may play a major role in estimating a tariff rate. For example, in the United States, several organs for rate estimation[39] submit applications for approval of the rates or the loss costs to the

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provisions; 4) Lack of efficiency: Post-assessment funding has the potential to cause delays in payments where a fund lacks sufficient liquidity to respond immediately, and administration of individual funds at the state level has the potential to create coverage disputes where an insolvency affects several guaranty funds. William R Feldhaus and Paul M Kazenski, 'Risk-Based Guaranty Fund Assessments; An Allocation Alternative for Funding Insurer Insolvencies' (1998) 17 *Journal of Insurance Regulation* 6-8.

37 Lemaire and Subramanian, above n 23, 31-32.

38 Skipper, et al, above n 2, 114.

39 For example, the ISO (Insurance Services Office) was established for rate estimation in the state of New York. The ISO, originally owned and controlled by insurance companies, provides rating and actuarial services related to property liability insurance, including the development of policy forms. It computes and publishes trended loss data for most property and liability insurance lines other than workers' compensation. The National Council on Compensation Insurance (NCCI) performs similar services for workers' compensation insurance. The members of the Office have been responsible for observing the tariff rate, while entrance into the organisation is voluntary. There are 5,000 insurance companies in the United States (About 3,000 of which are property-liability insurers). However, only a few of them have their own risk data for rate evaluation. Even those with risk data should refer to the ISO data when an insurance item shows a poor performance in completing contracts. Therefore, in reality, most of the insurance companies rely on the rate estimation organs to specify agreements, issue insurance policies, and estimate rates. Thus the member companies

regulatory authority of the insurance industry. Once the application is approved, an insurance company employs the suggested tariff rate without an individual approval process. However, the suggested tariff rate is not mandatory: an insurance company is allowed to change it within an allowable fluctuation band with simple notice.[40]

In most countries, privately managed insurance and reinsurance are not regulated with respect to rate estimation. However, there still exist ex-ante and ex-post rate regulations for other types of insurance. Particularly, in the developing countries, many insurance items are required to be ex-ante approved.

Social insurance (eg, compulsory automobile liability insurance, workers' compensation liability insurance) is rigorously regulated with respect to rates and policy forms. Auto liability insurance is one of the most rigorously regulated items.[41]

In the United States, life insurance is regulated through indirect rate controls (eg, mandated reserve requirements) instead of direct rate controls. In Japan and Korea, life insurance is regulated through control of rate estimation factors (eg, death rates, interest rates, and operation costs), which restrict effective price competition among insurance companies.

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of those organisations saved the time and expense involved with rate-filing. In the 1980s, however, this system was criticised as being anti-competitive. Critics charged that these bureaus were a form of price-fixing because the member companies were essentially charging the same rates. In response to this outcry, the ISO in 1989 and the NCCI in 1990 announced that they would stop providing advisory rates to their members; rather, they would now only publish trended loss costs. To these costs, insurers could add their own factors for expenses, profits, and contingencies. Specifically, no rating bureaus exist in the life and health insurance field. Changes in Business Environments of Insurance Industry and the Coping Strategies (in Korean), Korea's Insurance Supervisory Board, 201 (1995); Lemaire and Subramanian, above n 23, 32, 36-37.

40 Skipper, et al, above n 2, 117.

41 On the other hand, rate suppression, which can be defined as government suppression of insurance rates below levels that exist without price regulation, is likely to produce some reductions in quality, but several factors limit the magnitude of cost-saving reductions in service in response to rate suppression. First, reductions in quality may adversely affect an insurer's reputation in other markets. As an example, a reduction in capital and an increase in insolvency risk would affect all of an insurer's customers. Second, while insurers may be able to cut costs by imposing stricter standards for claims payments, these actions expose an insurer to litigation. They also might lead to regulatory action under unfair claims practice legislation. Third, while cost-reducing changes in levels and types of services in response to rate suppression might initially reduce insurer losses and pressure to exit, future rates could eventually be adjusted downward to reflect the savings in costs. For these reasons, quality reductions will not likely eliminate insurer losses from significant rate suppression. Scott E Harrington, 'Rate Suppression' (1992) *59 Journal of Risk and Insurance*, 185-189.

The regulatory authorities hope that competition among insurers will set the ceiling for premium rates, as consumers will naturally choose the product with a lower premium rate. For mutual insurance company or mutual association products, there is a further corrective for excessive premium rates, as policyholders benefit from unneeded surplus and dividends. The rates are also affected by the efficiency of the company's management. Those insurers that can lower the cost of management without decreasing productivity or quality of services[42] will be able to pass down the savings to the customers in the form of lower premium rates. The market competition will motivate the insurance companies to keep premiums low, while maintaining features that are attractive to the consumers. As a result, the regulators hope, the efficiency of insurance companies will improve, and consumers will have better choices at better prices. Excessive competition, however, will bring about rate wars, resulting in inadequate reserves or even insolvency.[43] The regulators, therefore, will have to monitor closely so that rate competition does not escalate to rate wars, which will eventually harm the public.[44]

Policies of Competition Inducement and Anti-Monopoly

The insurance regulatory authority is mostly concerned with the monopolistic status of insurance companies, which may disturb an efficient competition in insurance markets. With the increase in domestic and international mergers among insurance companies and with increasing integration and internationalisation of financial services, anti-monopolistic policy plays an important role in regulating the insurance business.

Insurance companies may form a coalition with respect to business operation, the use of insurance policy, and rate estimation to avoid bleeding competition, or may achieve a governing power over insurance markets through merger and

42 For example, under EU insurance regulations after 'Europe 92,' prohibiting supervision by price approval was expected to be highly controversial. Several countries, in particular Germany, Italy, and Portugal, operated supervisory systems which relied heavily on the prior approval of every product and premium rate. The position in Germany, for instance, was that every detail of the policy had to be approved in advance by the supervisory authority. However, the EC made it clear that it did not regard such prior approval mechanisms as compatible with an open competitive market. The clear intention of prior approval was considered to reduce competition, with the likely result that locally based insurers were given an advantage. However, several of the regulatory authorities which required prior approval were concerned as to how they would ensure that adequate premiums were charged if they had no right to check them in advance. They feared cut-throat competition, and, in particular, the 'dumping' of products by strong companies from other countries, ie the use of loss leaders to gain a foothold in new markets. Lemaire and Subramanion, above n 23, 10.

43 Eun Sup Lee and Jeong-Hwa, 'Regulation of the Insurance Industry in Korea' (1997) 6 *Journal of International Law and Practices*, 46-47.

44 Skipper, et al, above n 2, 122.

acquisition. Additionally, insurance companies that have already obtained strong positions in insurance markets may abuse the governing power through tie-in agreements, withholding of the covering capacity, or various other anti-competition tools. As a result, the regulatory and supervising authority in each country restrains anti-competition practices by establishing stipulations on collusive practices, merger and acquisition, and abuse of dominant position in insurance markets.

Concerning intervention in anti-competition practices, the regulatory authority enforces anti-monopoly laws and regulations in a pragmatic manner; that is, it generally accepts monopolistic practices when the advantages coming from such acceptance exceed the disadvantages caused by the regulation.

The success of competition regulations is dependent on how rigorously the regulations are executed. In the case of the United States, the competition law is being executed strictly. However, in Japan, the competition law is considered to be executed loosely, even though the law itself is strict.[45]

Anti-competition practices outside of the United States and the EU may be subject to the competition law of the United States or the EU, because of the 'effects doctrine'[46] that puts more emphasis on the influence of such anti-competition practices in the US or the EU markets than in those markets where the anti-competition practices themselves take place. As a result, US courts will judge an insurance business being operated overseas when anti-competition practices conducted by that business cause injury to US exports or affect US insurance markets.

The competition laws comprise the principles of prohibition and abuse. Conducting 'prohibited' practices as defined by the principle of prohibition is considered illegal, and is subject to ex-ante regulation. When an insurance practice is deemed

45 There are two tests for determining when a court has subject matter jurisdiction in the United States antitrust case: 1) the 'effect test' and 2) the 'choice of laws' or 'balancing test'. Neither can be found in the statutory provisions of the antitrust laws as both are creatures of judicial legislation. Under the effect test, companies carrying on business outside of the United States will come within the subject-matter jurisdiction of the United States court if their business activity is intended to affect US commerce and it is not *de minimus*. The effect test set out in United States v Aluminium Co of America has been criticised on several grounds. Because international business practices may affect two or more nations, some critics contend that the effects test would allow courts in several states to simultaneously apply different and conflicting anti-trust rules. Other critics contend that the test interferes with a state's sovereign right to control acts within its own territory. This criticism has led several other US courts of appeals to adopt a different rule known as the 'choice of law' or balancing test. This is the jurisdiction test that will subject foreign business to US anti-trust laws if factors showing a connection to the United States outweigh these showing a foreign connection. Ray August, *International Business Law* (1988) 174-176.

46 Skipper, et al, above n 2, 122.

illegal according to the principle of abuse, its illegality is confirmed by economic effects that are evaluated *post factum* (eg, United Kingdom and Switzerland).[47]

One reason for the United States' strict competition law is that the US has adopted the principle of prohibition and stipulates criminal prosecution when the regulation is violated. In contrast, the competition regulation in most countries stipulates only fines when the regulation is violated.

The competition law of the EU invokes the principle of prohibition and requires that the European Commission should be notified beforehand of market integration practices such as mergers within the EU.[48] Because the promotion of free competition is an important issue in international trade talks, the competition law will play an important role in liberalising and deregulating the insurance business.

Regulations on Intermediaries

Eligible insurance intermediaries are more important in free competition markets than in restricted markets where the differentiation of sellers and products is not commonly allowed.

The EU member countries generally observe the recommendations concerning intermediaries, which describe the range of insurance recruitment, classification of insurance recruitment, specialty, registration, and penalties. Although the recommendations are not mandatory, they are important in maintaining an orderly market because the consumers' dependency on insurance intermediaries has been much increased.

Insurance intermediaries should be continuously monitored by insurance regulatory authorities or self-regulatory bodies after they have qualified for business operation. Some countries (eg, Argentina, Brazil, Colombia, India) put a maximum limit on fees paid to insurance intermediaries. Most countries ban unfair business practices by insurance intermediaries that misrepresent policy clauses and benefits to the policyholders, add inappropriate funds to the insurance premium, or involve other forms of malpractice. Particularly, the OECD member countries regulate the intermediaries in life insurance very strictly.

47 Exceptions to the EU competition law are allowed for estimation of common pure premiums that should not be charged with any loadings, development of standardised insurance policy clauses, common coverage against particular risks (eg, coinsurance or co-reinsurance), and common rules for testing and acceptance of security devices. Skipper, et al, above n 2, 123

48 Skipper, et al, above n 2, 125

Conclusion

There exist two basic questions concerning regulation or deregulation of the insurance business: which part of the insurance business the government should target to regulate or deregulate, and in deregulation how the government should relax the regulations on competition among insurers, and between insurance businesses and other financial organisations.

First, the insurance regulatory authority should consider the interests of both parties: insurer and insured. For the insurer, the insurance regulatory authority should adopt a regulating policy with a view to promoting the management ability and creativity of the insurer. For the insured, the government should be careful in regulating or deregulating the industry to protect policyholders. In developed countries, regulations on financial requirements such as solvency have been tightened to protect insurance consumers, while regulations on the business operation have been relaxed. The insurance regulatory authorities of developing countries are being pressured to relax regulations to promote the originality of operation and to enhance competitiveness. At the same time the authorities are tightening regulations on solvency to protect policyholders. For insurance companies with good solvency, uniform regulation principles should be avoided and regulation of various aspects of the business operation should be abolished. On the other hand, for companies with poor solvency, regulation should be strengthened.

Second, the relaxation of restrictions on competition among insurers, and competition between insurers and other financial organs aim towards maximisation of efficient competition. The insurance market is always at risk of bleeding competition, because supply and production of an insurance product are relatively simple, and because insurance demand can be created only with limitation. To increase efficient competition in the insurance market, the insurance regulatory authority needs to deregulate the industry step by step within internationally acceptable boundaries rather than through hasty and uniform relaxation of regulations.

In conclusion, although liberalisation and deregulation of the insurance business are inevitable trends internally and externally, it is necessary to establish an efficient regulation system to facilitate competitiveness, efficiency in management, and policyholder protection