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Changing the Terms of the Regulatory Modernization Conversation: The New York Initiative

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Introduction

Within the property and casualty insurance industry, there is general agreement, perhaps even consensus, that the way in which insurers are regulated must change not incrementally but significantly. Nevertheless, when this concept clashes with the realities of the political process, there's often an understandable tendency on the part of the insurance industry to pursue whatever moderate change can be had rather than the wholesale change that is needed.

For many states, the first step toward insurance regulatory modernization has been passage of a commercial lines deregulation law. In several instances, however, these laws have applied to too few risks to be effective, and, consequently, another incremental step has been needed to expand the criteria defining a qualifying commercial risk. More recently, several states have made incremental progress in personal lines as well, but, again, political realities have often limited more ambitious proposals in various ways, such as restricting the degree to which insurers can adjust rates to a certain percentage per year or adding sunset provisions. This is viewed generally as progress, and, for the most part, the industry counts such developments as accomplishments even if relatively slight.

This typical state of affairs prevailed to New York, at least up until this year. Insurers in the Empire State operated within the relatively free environment of a flex-rating statute for many years until 2001 when the state's flex-rating law expired and was not renewed. Since then, reinstating flex-rating has been a perennial legislative objective of the industry. But this year, the New York Insurance Association (NYIA) decided to change the terms of the conversation by proposing not just incremental reform, but by advocating a comprehensive and complete reform package that would move the insurance regulatory scheme from where it is to where it should be.

The NYIA Proposal

NYIA's proposal (S-6550 filed by Sen. James Seward and A-10788 filed by Assemblyman Joseph Morelle) would eliminate price and product controls in competitive markets, but allow for their retention in markets that are not competitive as determined by a proven and objective standard.

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The proposal would not produce completely unfettered marketplace activity, as it would retain prohibitions against rates being "excessive, inadequate, destructive of competition or unfairly discriminatory" as well as requirements that policy forms cannot be misleading or violate state law. In short, if a market is judged to be competitive, insurers would be generally free to set prices and terms. Only if a market is less than competitive would there be substantial regulatory involvement.

The bill calls for use of the Herfindahl index, which is used by the Federal Trade Commission and the U.S. Department of Justice in the anti-trust context, to determine whether a given insurance market is competitive.

The index, calculated by adding the sum of the squares of the participants' market share, ranges from zero to 10,000, with the low range being highly competitive and the high range being less competitive. If a market has a score below 1280, it is considered highly competitive. A moderately competitive market is one that has a score between 1280 and 1800, and a score above that range would mean the market is considered insufficiently competitive.

For each of the three levels of competitiveness—highly competitive, moderately competitive, and noncompetitive—the legislation would establish a corresponding level of regulatory involvement. When a market is highly competitive, the bill would call for a file and use system in which insurers would not have to obtain prior regulatory approval for rates and forms. If a market is in the moderately competitive range, then insurers would operate within a flex-rating environment in which they would have some limited freedom to adjust rates. If a score indicates it is non-competitive, rates and forms would be subject to prior approval by the Insurance Department.

Even if a market is rated highly competitive, the Insurance Department would retain oversight to ensure rates are not excessive, inadequate, destructive of competition or unfairly discriminatory. Policy forms could not be misleading or violate state law. Additionally, a substantial increase of market share (10 percent or more) by a company in a single calendar year would trigger additional review by the Insurance Department and the state Legislature.

As NYIA has stated, the legislation would allow insurance companies to respond to consumer demands and to changing loss costs in competitive environments, while also ensuring that consumers are protected especially when a market is not competitive.

NAMIC's Position

NAMIC offered strong support for the NYIA regulatory modernization bill during the recently concluded legislative session and believes it is the type of reform that should be implemented in every state.

Regulatory modernization is NAMIC's top public policy objective for several reasons. Pricing freedom is the best way to ensure that insurance prices become neither excessive nor inadequate. Rating freedom enables insurers to make more refined rating decisions, which keeps rates stable. Insurers that can adjust their rates without regulatory approval can more easily lower rates with confidence that they will be able to respond to marketplace developments if necessary. Regulatory modernization allows insurance departments to concentrate their resources on matters other than day-to-day rate and form review.

More fundamentally, regulatory modernization is needed to reform and, thereby, preserve the state system of insurance regulation. The filing this year of federal legislation to create an optional federal charter for insurance companies highlights the fact that the state-based system of insurance regulation faces a substantial threat due to its inadequacies. Those who support increased federal involvement in the regulation of insurance do so in large part because they see it as the quickest way to achieve modernization, including removal of price controls.

The NYIA proposal represents a forward-thinking approach to achieving such modernization. Enactment of this legislation would encourage competition in the state's property and casualty insurance industry for the benefit of insurers and consumers alike. The result would be an enhanced insurance marketplace with more and better insurance products sold at appropriate prices.

The Significance of Reform in New York

Illinois has long served as the best example of a how insurance consumers can enjoy the benefits of competition in a state that has a diverse mix of rural areas and substantial urban development.[1] The fact that the state does not have a rating law on its books is more the result of historical happenstance than an

intentional reform effort.[2] That does not weaken its strength as evidence of the benefits of pricing freedom, but it may mitigate its power to serve as an example of the value of enacting regulatory reform.

With more than $21 billion in direct property/casualty premiums written, Illinois is the fifth-largest insurance market in the country, according to the Insurance Information Institute.[3] If New York, which is the second-largest market in the country with more than $33 billion in direct written premium, were to join Illinois in having pricing freedom for property and casualty insurance, the rest of the country would have to sit up and take notice.

Enactment of substantial reform in a state like New York could go a long way to picking up the momentum of insurance regulatory reform, a development that is sorely needed.

What Comes Next?

Given New York's highly charged political atmosphere, simply getting the initiative introduced in both legislative chambers this year has been a substantial accomplishment. In the development of insurance regulatory modernization, the bill's introduction is a significant event, and not just for New York. By getting it filed, NYIA sought to change the terms of the regulatory modernization conversation, and with luck the bill can have that affect in New York and beyond.

Instead of approaching the legislature and trying to determine what can be had in terms of progress, the bill serves to point to the place where regulation should be. Anything less (or more, to be precise) needs to be justified. As NYIA explained in its advocacy materials, the case has been made repeatedly that markets work better in the absence of price controls.[4] In other words, the industry should not have to explain why it wants modernization. Rather, the onus should be on those who favor restrictions to defend them.

NYIA has said it intends to seek the bill's reintroduction in the next legislative session. Whether the bill is successful in that session, or the next, or the foreseeable future is uncertain. It may be the case that the conversation will move, as it always does, to what is reasonably possible given the political realities.

It is quite possible, for instance, that the wholesale reform proposal will end up hastening incremental reform such as the reintroduction of flex-rating. Even though that would be far less than what the bill seeks, it would nevertheless be a very positive development. And the more ambitious proposal can still be cited as the kind of comprehensive reform that is generally necessary to improve the state system of insurance regulation.[5]

Endnotes

[1]See, e.g., Stephen P. D'Arcy, "Insurance Price Deregulation: The Illinois Experience," at www.aei-brookings.org/admin/authorpdfs/page.php?id=47.

[2]Id.

[3]See *The I.I.I. Insurance Fact Book 2006*, p. 29. The market numbers given are for 2004 and are based on National Association of Insurance Commissioners statistics.

[4]In its *Regulatory Modernization Initiative Legislative Memorandum*, NYIA stated the following: "There is widespread agreement among economic scholars that government price control is an inferior method for regulating price in any market where there are many sellers competing for the consumer's business. Insurance is no exception.

[5]Another example of the kind of regulatory modernization legislation needed to reform the state system of insurance regulation is the National Conference of Insurance Legislators' Property/Casualty Insurance Modernization Act, which was originally adopted by NCOIL's Executive Committee in 2001 and which has been amended and reauthorized, most recently at the organization's 2006 Summer Meeting. See www.ncoil.org.