Ritual and Reality in Insurance Regulation

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In recent months, we have seen one after another of our great institutions—public and private, national and local—come under siege, and the siege was usually laid down by people the institution was created to serve—its students, its citizens or its customers.

These events do not mean that our institutions have suddenly gone bad, but only that different things are now expected of them and that, when rigorously measured against new expectations, the institutions are found wanting. The events dramatize how difficult it is for an institution, especially a large and complex one, to adapt to the changing expectations of its constituents.

If institutions generally are not good at adapting to changes in their environment, government regulatory institutions may have special difficulty and be in special danger, for the regulatory process may bring out those traits that are most resistant to change.

In most regulation the public is only fitfully interested, and the regulator is insulated from public scrutiny by the complexity and obscurity of the regulatory process, just as the industry is insulated by the mere existence of the regulator.

Left alone with each other, the regulator and his industry unconsciously find a mutual interest in ritualizing their relationship.

The regulator must emphasize law and regularity, against the day he is challenged in court or denounced in public. He thus must look to form and detail, and may look away from the operating realities of the industry and from the expectations of the public. The industry relies on the rituals of regulation to make government behavior predictable and to keep the regulator occupied in areas where interference can be tolerated.

Inevitably, both regulator and regulated come to measure their effectiveness by their impact on each other, and come to live, often quite comfortably, within a closed system.

To what areas do the rituals of regulation tend to confine the attention of government? Often to matters internal to the market, attenuating competition, preserving the institutional structure of the industry, and balancing competitive advantage among entities of different form, sponsorship or regional allegiance. As a result, too much regulatory energy is diverted into policing the status quo in the regulated industry and into refereeing contests within it.

Those tendencies—to quarantine itself, to exalt ritual and detail, and to become distracted with internal problems of the industry—are, on the record, discernible in regulation of many kinds. It does not seem to matter what is being regulated or by whom or, in a narrow sense, how well. For the competent regulator the snare is not error; it is irrelevance.

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If we confine our minds to the rituals of regulation, we will resist change. But we will not prevent it. All we will achieve is to make certain that when change comes—and eventually change always comes—it will be dictated by the rebuffed and the frustrated, and not by us who would honor our institution, share its assumptions and value its continuity.

For any institution, the alternative to intelligent change is not permanence; it is extinction. For an industry regulated in the public interest, the alternative to regulation is not freedom; it is replacement.

To recognize the need for change, and to welcome it, is a sign of strength, not weakness. An institution that can justify evolution only by invoking the spectre of imminent disaster is likely to be an institution incapable of renewing itself from within. Better that we plan our changes calmly and without waiting for crises. In that spirit, I will propose today some changes for my own institution. I like to think they indicate that the New York Insurance Department—whose professional staff is the equal in competence, honor and dedication of any other body of civil servants anywhere—is capable of adapting and renewing even its most basic functions.

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Obviously, we are not concerned with change for its own sake, but only with change for the sake of helping the institution of insurance regulation do its job better. A good starting point is to identify the job, the purpose of our enterprise. Only if we have a clear idea of our overall mission can we have a standard for testing the usefulness of our specific activities.

Should we not try to express simply what we are about? Is it beneath our dignity to compress and weed out the complexities, so that we tell people what is worth their attention?

What, in simple words, is the public purpose of insurance regulation? What is government trying to accomplish that justifies all this activity?

A good, simple answer is that government is trying to help people get the most insurance for their money. This simple formulation does not tell all, but it contains some reminders of the purpose of regulation and some standards for determining whether our priorities are right—whether we are doing the things, and only the things, that further our public purpose.

Helping people get the most insurance for their money begins with helping people. We are reminded that regulation, as a government activity, should serve people. Putting it that way makes it sound obvious, but we have been discussing tendencies in the regulatory relationship that insulate the regulator from outside ideas and that tend to preoccupy him with ritual and with the internal problems of the industry—all of which can lead the regulator to forget whom he was put in office to serve.

The public-spirited regulator needs continuous infusions of the public spirit. If he recognized the danger that regulation will become a closed system, he must seek out ways to keep it open. In New York, we have been trying to go out to meet with the insurance-buying public and especially to seek out those people who are most disaffected with the institutions of insurance and insurance regulation. This is not easy, and certainly it is not always pleasant. But tranquility is not the ultimate value in the public service, and it is part of the work of the regulator to welcome, on a continuous and constructive basis, the fresh thinking of those whose only connection with insurance is being the people insurance is supposed to serve.

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The phrase "helping people get the most insurance for their money" contains a number of other ideas, and I would like to take them up one at a time, and suggest ways of furthering each of these aspects of our public purpose in the regulation of property and liability insurance.

First, helping people get the most insurance for their money concerns, among other things, a person's ability to get insurance.

The availability of insurance has great economic and social value. The accepted loss ratios in much of property and liability insurance indicate that people so value the ability to transfer certain risks of living that they will contribute a third to a half of their premium dollar to the operating expenses of the risk distribution system. It is no wonder that a public which is willing to pay that much to spread certain risks will react forcefully against what it regards as an unacceptable curtailment of its ability to spread those risks.

Generally, government can be expected to act to strengthen or replace the private insurance mechanism when the shortage of insurance is serious enough and the social cost of not acting—that is, of leaving the individual to take his chances alone—is too high. When government decides it must act—as it has done in auto assigned risk plans, fire insurance pools, catastrophe reinsurance, Medicare, workmen's compensation funds and bans on racial discrimination in underwriting—it can anticipate strong support from the public, for the public encourages government to look beyond insurance as a private contract to insurance as a public function.

Residual markets change, and the work of the industry and government in strengthening those that are socially intolerable is a work that is never finished. It is in the interest of the industry, just as it is the duty of government, to identify and act on those problems early and forthrightly enough that they can be solved with the minimum of suffering and ill will and with the minimum disruption of the private insurance mechanism.

We have such a situation today in auto liability insurance. Auto liability underwriting leaves as residual risks many people who, on their individual merits, may present no special hazard and who—because they are young or old or poor—may be least able to sustain a liability in excess of their insurance protection.

We already have a mechanism for strengthening the market, but it is out of date. The New York Automobile Assigned Risk Plan provides only the limits required by our compulsory insurance law. While it is logical that the Assigned Risk Plan can supply no less, there is no reason why it cannot supply more. In New York today, 10/20/5 protection is so inadequate as to be foolhardy for the driver and cruel to the victim. We simply need to keep our institution up to date. We can do so by increasing the amounts of liability insurance available through the Assigned Risk Plan, and providing auto physical damage insurance through the Plan, at a rate based on experience in the Plan.

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Helping people get the most insurance for their money contains a second idea—that of getting the most insurance, or of making sure that the insurance product is of high quality and reliability.

Experience in many fields has shown, not surprisingly, that where a promise of future performance is sold for present dollars, the buyer is at the seller's mercy. Where, as in insurance, the promise is complex and the seller is more powerful than the buyer, the disparity between the two parties' abilities to look out for themselves is marked.

So for a long time government has stood with the buyer in helping assure the quality of the product. Examples are in the regulation of policy provisions, to see that they are clear and fair; in regulation for solvency or its equivalent, to see that the promise can be performed when it comes due; in regulation of the relationship between insurer and policyholder, to see that the promise is indeed performed fairly and that the buyer's reasonable expectations as to what he bought are not too rudely disappointed.

What the buyer of insurance is paying for is protection against a certain kind of economic loss for a certain time. Much of the value of the protection comes from the buyer's ability to plan on the basis of it, to use it in enduring commercial relations and to draw from it peace of mind.

All those values are undermined if the insurer cancels at mid-term, through no fault of the policyholder. Statutory policy forms have indeed long provided that the insurer may cancel at any time and for any reason. Yet underwriting techniques and management controls have improved to the point that companies should not suddenly wake up to find themselves overcommitted—or at least should no longer have the luxury of rectifying their error at the sole expense of those to whom they have sold their word.

In auto liability insurance, a public outcry against cancellations brought swift enactment of anti-cancellation laws in many states, including New York, often with broad industry support.

Events of the past year make it appropriate now to extend reasonable protection against cancellation to policyholders in the other personal property and liability lines. It is now clear that only law can establish those uniform minimum standards of conduct which will remove from susceptible managements the temptations to economize in ways that alienate the public from the institution of insurance. Such standards of conduct are in the interest not only of the public but of the vast majority of insurers who underwrite carefully and then stick by their policyholders. A business that sells promises depends, in the long run, on the trust of its buyers.

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Another aspect of the reliability of the insurance product is the guarantee against loss due to insolvency of an insurer. Vigilant regulation can reduce company failures, but no government or private agency has ever devised a foolproof way of insulating any financial institution from insolvency.

Recognizing that despite everyone's best efforts there will be insolvencies, the Federal government (for banks and savings and loan associations) and New York State (for life, workmen's compensation and auto liability insurance), among other jurisdictions, have set up devices for spreading across the industry the cost of saving harmless those citizens who were owed something by the fallen brother.

Is this fair? Are you your brother's keeper? Sometimes, in a competitive economy, he who asks the question slew his brother, and the voice of his brother's dependents cries out unmistakably. But regardless of fault, society has only three places to let the loss fall—on the policyholder, on government and on the entire industry. Of the three the policyholder is probably most innocent and least able to shoulder the misfortune. The general revenues of government would be a fair target, at least for those insolvencies traceable to defects in government regulation, but it is unlikely that the public would accept the exposure without exacting minute control of the day-to-day operations of every company. From society's point of view, then, simple elimination suggests that the industry or, rather, the policyholders of all companies, should share the cost.

The cost of protection, spread among the many, is small; the cost to the individual of having trusted in a worthless policy can be catastrophic.

In New York, we can extend insolvency protection by building upon an existing institution. Our Motor Vehicle Liability Security Fund contains $125 million. Interest alone adds $4.5 million a year, and each year our motorists contribute another $7 million. Yet in the Fund's 21-year existence only $6 million has been drawn out of it, and all indications are that the frequency and magnitude of insolvencies do not increase in proportion to overall premium volume.

The motorists have paid enough, and, without diminishing their protection, we can build upon this unique security fund to extend similar protection to other policies held by these same people and by others. Auto insurance as now written is no more a threat to company solvency than are other lines. A person is no less deserving of insolvency protection behind his general liability policy or his homeowners policy than behind his auto policy.

By simply discontinuing assessments on auto insurance policies, commencing assessments on other lines and broadening the Security Fund to cover all personal and small commercial lines, we can make an immediate improvement in the reliability of the promises sold by insurers to the people of New York State. By providing for all assessments to cease when the Security Fund has reached a specified dollar amount, we can achieve equity as among insurers and can guard against the sterile accumulation of funds in excess of the public need. By providing for assessments to resume if the Security Fund is ever drawn down a specified amount, we can assure that all our policyholders are as fully protected against loss due to company insolvency, at any time in the future, as our auto insurance policyholders are now.

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The third part of helping people get the most insurance for their money concerns their money, that is, the price they have to pay for the insurance protection they buy.

In a national economy that looks to the market to set prices and to allocate resources, property and liability insurance has long enjoyed, or suffered from, a separate existence. Not too long ago, the paradigm of the property insurance pricing system was the cartel. Competition, such as existed, was assuredly not price competition at the consumer level, and elaborate private governments were maintained to make sure it stayed that way.

Like other institutions that rested immobile while the mores of the national economy and the expectations of the public changed about them, these private governments and the cartelized insurance market were overthrown.

The cartels may be dead, but they still rule us from their graves. Our present rating laws were enacted partly to insulate pricing cartels from antitrust attack, partly to impose social control over the practices of those cartels, and partly to preserve inviolate the regulatory jurisdiction of the states.

Government activity which was relevant to conditions twenty years ago, may not be relevant to conditions today. If the institution of insurance regulation is to be able to renew itself from within, we must evaluate what government now does with respect to insurance prices in the light of current market conditions and in the light of the current needs of the buying public.

Since the prevailing rate regulatory laws were enacted, the property and liability insurance business has refined its pricing and underwriting methods, has grown and become more sophisticated, is exhibiting more diversity in price and distribution, and manifests a real willingness to compete in price. While much is still to be learned about insurance market structure and conduct, the structure is propitious for real competition—entry to the industry is easy, concentration is low, sellers are numerous, the product is largely undifferentiated, and total sales are expanding rapidly.

The public has an immense stake in the results of the insurance pricing and rate regulatory mechanisms, but it would seem to have no stake in the form of rate regulation apart from wanting that which yields the best result. What are the results desired of any system of rate regulation? To the buyer, the best pricing system would seem to be the one that yields prices as low as possible, stable prices not subject to large and sudden changes, and prices that are fair as among policyholders. The buyer also gains if the chosen system of rate regulation furthers other public objectives—if it increases, rather than decreases, the likelihood that insurance will be available and reliable.

The system should fit the current realities of the market and should direct our regulatory energies at what actually happens rather than into rituals that bear no clear relationship to reality. Finally, unless it is impractical or against the public interest, our insurance rate regulation should harmonize with general norms for conduct in the economy.

In my judgment and that of my top colleagues in the New York Insurance Department, the present needs of the people of the State of New York would be better served by a rating law which would not prescribe that rates be filed for the approval of the Superintendent. The watchfulness of our skilled examining staff would be directed at what was actually being charged in the field, rather than only at the ritual assertion, in a rate filing, of what a company proposed to charge.

Under this system the forces of competition would be allowed to keep rates down. When cost decreases called for lower rates, the rates could be reduced at once. When cost increases called for higher rates, the rates could be adjusted without delay and hence without even temporary restriction of the availability of insurance. In all cases of aberration—where a rate was excessive, inadequate, discriminatory or destructive of competition—the Department would have full power to suspend or disapprove the rate.

A system of regulation that relies on competition is valid only where competition exists. In any area or kind of insurance in which price competition at the consumer level was insufficient to assure that rates would be neither inadequate nor excessive, the Department should be able temporarily to reimpose prior approval. Such a power would be especially helpful in minimizing dislocations during a transition period and in protecting residual markets. It would also protect the insurance-buying public against any failure of resolve by those in the insurance industry who now profess a desire to compete, but who may merely wish to stabilize their condition on a different and more congenial basis.

In New York, we can expect that a change to more competitive insurance rates will cause some rates to go up and some to go down. We should not anticipate any overall change in rate level as a result of the change in regulatory procedures. The important difference is that rates would be responsive to current costs and markets, instead of being excessive for some risks, which are then overly courted, and inadequate for others, which are shunned and fall into the residual markets.

Those who do not wish to compete in price have conjured many possible evils of open competition. For example, will it lead to rate wars? During the past 50 years, there has been no evidence in California (where rate filings are not required) or in any other jurisdiction that rate competition leads to destructive rate wars. Their memory haunted the Merritt Committee a half century ago, but our own experience and the findings of the most recent Congressional study should lay the spectre to rest.

Similarly, there is no correlation between kind of rating law and the incidence of insolvency, and certainly no evidence that competition leads to insolvencies. If anything, one can infer from recent episodes that rate inflexibility creates pockets of unmet demand that invite the creation of marginal companies prone to fail.

Nor is there any indication that rate competition, given strict antitrust and examination safeguards, leads to higher rates than a prior approval law responsibly administered. Quantitative comparisons between different markets are far from conclusive, but a comparison of loss ratios of like companies in California and New York suggests that rates are similar.

Equally important, experience suggests that more competitively responsive rates lead to greater availability of insurance and to greater public satisfaction with its quality.

We are not limited to a counterfeit choice between regulation alone and competition alone to protect the public. Both are available, and we should use them in combination. To make competition and regulation reinforce each other best in ways relevant to current realities, it is now time to let competition work with less restraint upon the market price of insurance.

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Those four changes—easier access to needed auto insurance, protection against cancellation, security in case of company insolvency, and open competition in rating—will help the property and liability insurance industry serve the public better and will focus our regulatory energies on real current problems.

By the end of the year, the New York Insurance Department will issue a report, refining the four proposals and setting out the documentation for them, so they may be considered at the 1969 session of our State Legislature. Meanwhile, we will seek the views and technical advice of the public, other government agencies and all segments of the insurance industry.

These four proposed changes in the institution of insurance regulation are part of an attempt to keep that institution responsive to current public needs and to current realities within the regulated industry. Even if sound today, the four proposals should be looked upon as adaptations and not as permanent improvements, for that which is devised to be permanent is often, in the long run, no improvement at all.

Regulation is the process of bringing current values of society to bear on current practices of an essential industry, and hence regulation must seek relevance more than permanence. If we in government keep in mind, in simplest terms, what our goals are, we will be best able to pursue those goals relentlessly.

If the limited resources of public attention and government power are to do the most good in insurance regulation, they should be directed at helping people get the most insurance for their money. Our efforts can be measured by how they affect the availability, reliability and price of insurance. If we can orient our complex and venerable institutions to those simple, current goals, we will renew them from within, and they will endure—and deserve to endure—when their rituals are forgotten.