Information Technology

and

Insurance Agent Licensing

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Executive Summary

Recent advances in information technology are changing the insurance business. Some of the changes are hidden away in the back office, invisible to the public. But dramatic changes are coming in the most visible part of insurance, its sales or distribution function. The technological advances place in the hands of insurance companies and agents the tools to bring new savings and better service to consumers. That opens the door to rapid shifts in the winners and losers in this highly competitive business.

These developments challenge state insurance regulation as much as they challenge insurance management. State regulation is based on small geographical jurisdictions. Insurance regulation is based on old definitions of the financial service being regulated. Information technology leads to the breaking down of familiar limitations, geographical and functional. It is beginning to do so already.

The aspect of insurance regulation likely to be hit first by today's and tomorrow's technological change is the licensing of insurance agents. It is perhaps the oldest kind of insurance regulation. If it is not modernized quickly, it will become a needless impediment to the implementation of the new technologies. It will not for long stand against changes so profound. But even a brief delay will harm the public and, ironically, the segments of the insurance industry it is presumed to be protecting.

This report describes what is going on today in the intersecting areas of information technology and agent licensing and the unfortunate consequences – for the public, the industry and the regulatory agencies – of applying to an emerging twenty-first century business a regulatory structure carried forward nearly intact from the nineteenth.

Technology and Insurance

Rapid advances in information technology are changing the way business is done everywhere. Digitization has made it possible to process and communicate information faster, cheaper and more easily and reliably than ever before. Businesses are using information technology to improve quality, to lower costs and to design new products and services. It is a powerful tool for competitive advantage in increasingly competitive, global markets.

The insurance business is being changed by information technology too. Exactly where the change is leading is unforeseeable, but change is inevitable, and intelligent participants in the insurance business will want to take advantage of it.

Insurance has been no stranger to technological change. Over the years, the business has lowered expenses by embracing new technologies in communications and automation. Insurance has brought to the public the economic benefits of declining loss costs as other technologies brought better health, longer lives, fewer fires and safer factories and highways. In recent years, information technology has lowered the capital costs of insurance through the unbundling of insurance products and through the risk management movement. Over and over again, consumers benefited. Competitors who rode the changes gained over those who resisted or ignored them.

Regulation will play an important role in determining how quickly and under whose auspices the latest round of advances in information technology gets to the public through the marketplace. For the main way technology gets to market is by giving one competitor a significant edge over another. With technology moving so quickly forward, the competitive advantages and the shifts in the competitive pecking order will naturally tend to come quickly too. But even where their long-term effect on

the public is beneficial, rapid competitive shifts are difficult, disruptive and upsetting to those in any business that is subjected to them. That is where regulation comes in.

Regulation can affect the pace or rate of change, not its direction but the time it takes to get there. Where regulation finds itself already athwart the path that change is taking, regulation is in a natural position to slow change down. And it may be disposed to do so. That is not necessarily bad where the regulated field is alone, left to its own devices and in control of its destiny. But in financial services, insurance is not alone. In the real world of applying public policy to insurance, the state insurance commissioners are not alone.

State regulation of insurance, like all regulation, has not always dealt easily with rapid change that was upsetting to the regulated business. Regulation has a tendency to guard its jurisdiction over the regulated activity and to side with constituents who feel threatened by change. Sometimes regulation has resisted innovations made possible by information technology. But where a technological advance lowered costs or otherwise served both sellers and buyers, it was not held back for long.

The forces of regulation and information technology are about to collide in the distribution of insurance. Information technology is making it possible to distribute financial services at low cost and in convenient and attractive forms. Those possibilities will not naturally respect the borders among nations, let alone states. They will not naturally submit to our inherited distinctions among the various financial services.

It is in the nature of advances in information technology to leap over borders of geography and boundaries of profession. It is in the nature of regulation to respect and enforce those borders and boundaries and to try to make them permanent. So the changes based on recent advances in information technology will inevitably run up

against regulation of many kinds. The most exposed aspect of insurance regulation – the one likely first to be seen as standing in the way of the competitive use of the technological gains – is the licensing of insurance agents.

The Licensing of Insurance Agents

Agent licensure began in the nineteenth century for reasons that have little to do with how the insurance business works today. Back then this large country was sparsely settled. Communication was slow, expensive and unreliable. Time for travel from the coast to the interior was reckoned in weeks. Insurance companies doing business beyond their home towns had to delegate a lot of authority to their local agents. In the tiny towns sprinkled across the land, there was not even enough insurance activity to support a full-time agent, but it could be a sideline for the keeper of the general store or for the town lawyer. So an insurance agency in those days was not an organization. It was one person.

States began licensing those agents because the states, like the insurance companies, needed someone present on the local scene. States got revenue from insurance by taxing premiums. The big insurance companies were not local but were in the Northeast, mainly on the coast. For a tax collector, that could be too far away, so far that those companies even came to be called "foreign". So the states looked to their local agents to collect the taxes owed by foreign insurers. Licensing the agents gave the states the ability to keep track of them and to punish them, by revoking the license needed to stay in business, if the agents did not come through with the tax payments.

Some fifty years later, in the early decades of the twentieth century, the states began licensing agents of in-state ("domestic") companies as well. The reason was that the states were pursuing a new and more demanding objective – the control of

competition. For that they needed to reach all the insurance companies and all the agents. Why control competition in American insurance when the same country at the same time was celebrating economic competition and enacting anti-trust laws to enforce it? Because financially reliable insurance companies had come to be seen as essential to the country's development, and unbridled competition was seen as threatening them.

As people came off the farms, causing the tiny towns to grow into little cities, they needed fire insurance. Their houses, stores and workshops were built of wood and sat side-by-side. An aspiring city could burn down in a day, and insurance provided the money to rebuild. The same people needed life insurance. The mother and children no longer had the farm to live on and hand down through the family when the father died at forty. When fire insurers and life insurers went broke or just became unsteady, people suffered and worried. Unrestrained competition seemed destructive of the reliability of such important social institutions. So public policy toward insurance turned against price competition.

In those days even more than today, life insurance agents and fire insurance agents had a lot of practical influence over insurance prices. At the point of sale, they did the underwriting and the rate classification. Commissions were large, and an agent could shave a price by rebating some commission to the customer. For the state to restrain price competition, it needed power to restrain the agents. Licensing all agents – for domestic as well as foreign companies – gave the state that power, for a license once granted could be revoked.

Later still – starting in the 1930s – the states' reasons for licensing changed again. Using agents as the fulcrum for gathering taxes and restraining competition receded in importance. State government turned its attention to raising professional standards of agents and to protecting the agents themselves against competition. The

two new motives often went hand in hand, making it difficult to disentangle one from the other. Raising professional qualifications was often a worthy idea. Once the state's licensing power was behind it, setting agent qualifications could also be used to bar various unwanted competitors from the business. With less subtlety, some states passed resident agent laws that quite openly employed the licensing power to protect local business interests against outsiders.

As the purposes of licensing agents changed over the years, the mechanical requirements nonetheless preserved much of their original focus and impact. Licensing is personal as it always was, being required of the agent as an individual more than of the agency as an organization. Licensing is local as it always was, being governed by where the customer is, not by where the agent is. That means a separate license, and a separate licensing process, for every individual agent from every state in which the agent has a customer or helps cover a risk. Requirements may or may not be consistent from state to state, but the key fact for multi-state business is that they must be complied with again and again. And often not far in the background is the recurring purpose of licensing to protect some local interest or to restrain some kind of competition.

The Collision of Technology and Licensing

Obviously no one can predict exactly how information technology will affect insurance in the future. But it is pretty sure to lead to cutting costs, to blurring functional distinctions and to crossing jurisdictional and geographic lines. That is what it has done over and over in the past. It is starting to do so now in insurance as in many other businesses.

Those tendencies of technology will bring it quickly into conflict with the local, personal, repetitive and protectionist aspects of agent licensing. With all of

technology's promise to improve the consumer's lot, and with all the real challenges which technology will surely bring to insurance regulation, it would be unfortunate and embarrassing for insurance regulation in general to be drawn into a posture of opposition to the competitive use of technology to reduce costs and improve service. That would be especially so if the first and most conspicuous point of conflict involved an aspect of insurance regulation so rooted in the past and not the present.

Just as regulation should hope to avoid obstruction of technological advance, so should the insurance agents whom much of license regulation is designed to protect. Obstructing competitive change driven by technology, or maneuvering regulation to obstruct it, is not usually in the interest of the business groups most directly involved. The reason is the economics of market intermediaries.

Market intermediaries, including insurance agents, bring buyers and sellers together. Their economic justification is that they sell their service for less than it would cost buyers and sellers to get together on their own. Bringing buyers and sellers together is a process of gathering, processing and communicating information – information about needs, products and services. Anything that changes the value of that information or the price of handling it opens the way for meaningful improvements in service and reductions in price and hence opens the way for competitors.

In prior episodes in which technology changed insurance markets, regulatory rules and business practices of the prior era held back the established industry leaders as they tried to adapt. Sometimes regulation held them back long enough for competitors who were not so caught up in tradition to take over leadership of the market. Those episodes illustrate the general risk to insurance agents and any other business establishment in relying on regulation to hold back the competitive impact of technological advance.

Such a tactic feels good but it almost never works for long, and when the legal barriers come down, the hitherto protected segment is in a particularly bad position. For the old establishment is most apt to have sunk costs in outdated technology. The old establishment is most exposed to price-cutting that accompanies the entry of new suppliers. And the protected segment is likely to have become dependent on the existence of a pervasive regulatory system, whereas the new competitive battleground will likely have opened with no regulation at all.

Besides the counter-productiveness of regulatory protection against technology, what is worrisome about agent licensing as a protection is that the current round of advances in information technology are likely to bring so many opportunities in the distribution of insurance. Taking advantage of the opportunities will surely be more valuable in the long run than any protection against the threats. But the danger is that those opportunities will not be as accessible to the present players as they are to someone else. Fences put up to keep outsiders out can easily work to keep insiders in.

Conclusion

While regulation should not needlessly impede the competitive deployment of advances in information technology, that is not to say all technology is good and all regulation that stands in its way is bad. A balance needs to be struck, but the first move has to be from the regulatory side. For in its present posture, agent licensing regulation cannot, just as a practical matter, withstand this kind of technological advance. More important, it should not wish to try. The regulation at issue is too out of date, and information technology has too long a record of lowering costs and improving service. Moreover, the insurance business has too many competitors in finance and state regulators have too many competitors in making public policy for insurance.

The insurance business and many aspects of its regulation have come a long way in the century and a half since the pattern for agent licensure was laid down. But agent licensing has not changed much, and it is about to get needlessly in the way of market changes driven by technology. If that comes about, the odds are that ultimately regulation will lose out and the general institution of state regulation may be made to look obstructionist and anachronistic.

People who want to avoid that outcome should start now to modify the licensing rules so as to achieve current public goals without taking an excessive risk of getting run over by market changes. The modification will surely be in the direction of simplifying the licensing process as it is experienced by business people who must comply with it. A sound simplification here, as elsewhere, will need to be grounded in a deeper understanding of all elements of the problem than we usually need to possess. People trying to head off a technology-licensing collision on a sound basis will need to know how technology works in insurance markets, and they will need to know how agent licensing works in insurance regulation. This report is intended to be a source of that sort of knowledge.

Introduction

The purpose of this report is to call attention to an impending collision between two familiar insurance institutions or accepted ways of doing things. If the collision occurs, choices will have to be made between the two. It is not clear how or by whom those choices would be made, and it certainly is not clear what the outcome would be. Yet both institutions are valuable, and a choice between them ought to be avoided if it can be.

The two familiar insurance institutions are, one, the continuous and long-familiar efforts by the insurance business to use new technology to make itself more efficient, and, two, the even longer-established efforts by the states to advance the public interest by licensing insurance agents. On the face of it, both efforts are laudable and it is not obvious why they should ever come into conflict, let alone why we should fear anything as dramatic as an imminent collision.

What is bringing the industry's attempts to gain efficiency onto a collision course with regulation's way of licensing agents is a group of recent advances in information technology. To avoid the costs of collision we need to see what is coming. To see that we need to learn more about both of the institutions involved – the competitive uses of technological advance in insurance and government's licensing of insurance agents – than we would normally need to know.

This report first looks at the business aspect of the situation. It describes the technological improvements in handling information. Then it examines what the insurance business will be led by competition to do with those technological improvements.

Turning to the regulatory side of the situation, the report sets out the history and development of state licensure of insurance agents. It is a very old regulatory activity, one that addressed an insurance business conducted on a far more local and personal basis than today. The report traces the evolution of agent licensing over the years and its changing public and private purposes. Finally, the report looks at why the collision is almost sure to take place if we do not take steps now to avoid it.

Part One: Technology and Insurance

In American insurance and across the world economy, the technology of handling information is changing rapidly and in ways that can alter whole industries in almost no time. To see them more clearly, it helps to arrange the many technological changes into four groups.

First, information of more and more kinds is being collected in or converted into digital form. Every number, word, sound or picture that can be put in digital form is being put in that form.

Second, the information can be processed. Once in digital form, it can be stored, compiled, arranged and compared by digital computers. The computers have far greater capacity and speed than was imaginable just a few years ago and they cost far less.

Third, the computers are everywhere. They are smaller, tougher and handier. They are little boxes in offices, homes and briefcases and chips in cars, TVs and barcode scanners.

Fourth, the digital information can be communicated – from computers to people and from computers to other computers – in a widening variety of ways. Like the computers, the communications devices and methods are getting faster, cheaper, handier and more reliable. While technology is sure to continue moving forward rapidly on all four fronts, the progress in digital communication is apt to be particularly dramatic in the next few years.

Technology does not produce social and economic change by itself. Change comes about because of what technology enables people to do. In business, that means

what they do competitively. It may be a new product or service. It may be higher quality or lower cost. Today the confluence of advances in the various aspects of information technology is making possible such competitive changes all over the world economy. Some scholars think it adds up to economic change unseen since the confluence of new technologies, attitudes and institutional arrangements we call the Industrial Revolution.

Applications of Information Technology

In the past fifteen years, advances in information technology have made possible some very large changes in the way business is done all over the world. The changes are well known and we will just refer to them and then move on to insurance.

The technology is behind the big changes in individual firms. It accounts for the elimination of layers of middle management from all kinds of corporations. The information those people gathered, analyzed and reported can now be dealt with directly, both by workers on the factory floor and by senior executives. The technology is behind the marriage of custom design to accurate and inexpensive manufacturing. Formerly they were the mutually antagonistic provinces of hand craftsmanship and mass production.

The technology is also behind the big changes in entire markets. It accounts for the opening of markets on a truly worldwide basis. Nobody anywhere can be ignored as a potential client or competitor. Nobody is too rich to please with computerized design, nobody too poor to reach with automated cost cutting. In finance, the technology is behind the securitization of receivables – mortgage and credit card debt, personal and small commercial loans – and the emerging securitization of contingent payables like hurricane losses. Securitization has brought lower costs to borrowers and

nothing but trouble to commercial banks which, moments before, had that business all locked up. It provides and threatens insurance with an inexhaustible supply of capacity.

As to insurance company operations, it is impossible to foresee exactly how and how quickly the insurance business will pick up the new technologies. The business is complex and conservative. It is under immediate pressures for profit, and it is not accustomed to big investments with long waits for a payoff. The industry was quick to use automation in its record keeping and processing functions. It has been slower in the traditionally professional ones, such as underwriting and claims. Nonetheless the potential seems very great. Consider some core activities in insurance and how akin they are to tasks that information technology has shown it can help do better, faster and cheaper.

Much of the reasoning process in underwriting resembles credit scoring: so much for this characteristic, so much for that. Much of it resembles branching and decision trees: if the answer is A, then the next question is B, if not, then C. Much rating is a long sequence of simple calculations and the feeding of formulas. Much underwriting communication is of multiple-choice responses to scripted questions and inquiries into databases inside and outside the insurance company. Adjusting claims requires building a coherent file out of many facts and a succession of communications. Adjusters have to be able to react and respond quickly to new information, based on familiarity with the whole file. Throughout an insurance company, a perennial problem is identifying and getting to the right person, the area or subject specialist or the account executive, and then giving that person all the necessary information. All those activities certainly look like prominent candidates for improvement or partial replacement by various capabilities of information technology.

Technology and Insurance Costs

The main way information technology has affected insurance in the past has been by lowering costs. Insurance costs have three components – expenses, losses and capital.

On the expense side, technology has driven reductions in distribution and general overhead. Examples are the use of the mails instead of personal visits, typewriters instead of pens and computers instead of ledgers and file drawers. Often the changes resembled the introduction of factory methods and scale economies into a craft. The overall expense levels of the life, health and property-casualty businesses have declined steadily over long periods. Some of the decline has come as individual managements used technology in the continuous improvement of individual companies. But most of the reported decline in expense levels for the whole industry has accompanied shifts in market share from one kind of company to another. Share has gone to companies whose way of doing business enabled them to capture quickly the savings that technology made possible, while other kinds of company were held back long enough to lose out.

On the loss side, technology has brought down the cost of claims and benefits. Sometimes the reduction came from improving the insurers' ability to analyze insured loss experience with an eye to prevention or deterrence. Sometimes it came by improving their clients' ability to avoid losses entirely.[1]

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[1] The greatest profits in the history of insurance have come from the ability of the entire industry to keep prices consistently above a declining curve of insured losses. Those long, steady declines in losses came from a combination of the technology of insurers and the technology of their clients. Downward loss curves have been so gradual and society-wide that we sometimes take them for granted or overlook their specific impact on insurance. Illustrations are sturdier ships reducing losses for marine insurance, longer lives reducing life insurance claims, fire resistant construction for fire insurance, diet and hygiene for health insurance and safer roads and workplaces for auto and workers compensation.

Overlooked until recently has been the third component of insurance costs – capital. Information technology can sharply reduce capital costs of the insurance function. That impact is clearest in the unbundling of insurance products and in the risk management movement. Technology is making it possible to get the insurance job done with less cost to the customer, regardless of who performs any particular function. It does so by reducing the amount of insurance company capital that has to be dedicated to absorbing insurance risk.

Consider first the unbundling of two traditional products of the life insurance business – cash-value life insurance and deferred annuities. Traditional life insurance combines mortality and investment elements. It guarantees cash value, face amount and policy loan rights. Agent commissions are figured as a percentage of the total premium.

Information technology now makes it easy to break out the cost and yield elements of these products. It will support frequent interventions by the policyholder to change the balance of investment and mortality and otherwise to tune the insurance to his current circumstances. Heavy users of that technology are variable and universal life insurance and many sorts of variable annuities. They separate the mortality and investment elements and let the policyholder take on as much risk and control of the investment element as he desires.

As it gets easier to take apart the life or annuity product, the policyholder becomes better able to keep himself informed. He can search the market himself, with less assistance from an intermediary. He becomes less willing to pay substantial commission on what looks like an investment deposit. The company needs less capital behind the unbundled product and less actuarial and sales support for it.

The unbundling of life insurance demonstrates, among other things, that when we examine the impact of information technology on insurance, we have to look beyond the improved technology of the sellers. As important is the technology of the buyers, their increased ability to inform themselves, to perform tasks and to shoulder risk.

The second ongoing reduction in the costs of getting the insurance job done is the risk management movement in commercial property-casualty insurance. Traditionally commercial rates were broken only into broad categories, with significant cross-subsidy among policyholders. Rates were quoted gross (with commission) only. The risk-bearing and service elements of the insurance relationship were bundled inextricably together. Now information technology makes it not only possible but convenient and easy to track the different elements of the insurance product and to perform the finest analysis of patterns of loss for each insured.

Led by the large brokers and their corporate customers, buyers have forced insurance companies to unbundle their product and offer it at the levels desired. Low levels of risk can then be retained. Services can be redesigned and purchased one at a time. The corporate client saves money in a number of ways, chiefly by eliminating cross-subsidies, by taking over some of the service functions and by not paying an insurance company for capital the client is not using. Corporate insurance buyers had long sensed such savings existed and were eager to get them. The risk management movement advanced right on the heels of the enabling technologies.

Risk management is often thought of as the province of large corporations. That is where it started, because the savings from risk retention were greatest there and gathering the data was simplest. But risk management has gone much further. In techniques, it comprises simple risk retention, highly loss sensitive rating, dedicated and shared captive insurers and entities in the “alternative market” of non-insurance

organizations and insurers outside the reach of American regulation. More fundamentally, risk management shifts the way insurance is conceived. It sees insurance as merely one way of dealing with a problem of financing extrinsic risk. The recent experiments with securitization of exposure to property catastrophes, such as hurricanes, are yet another way of reducing capital costs by sidestepping the use of a capitalized insurance company as intermediary.

Far from being confined to the Fortune 500, the risk management movement now reaches between a third and a half of what was and would have been the conventional, commercial property-casualty insurance market. And it is not the worse half. Good risks are easier to retain than bad. The low and predictable levels of loss are easier to retain than the high and uncertain ones.

In personal insurance, both life and property-casualty, information technology now enables insurance companies to analyze claims and demographic data as finely as they wish. They have many uses for such analysis. They may use it for pricing closely against costs or aggressively to penetrate new market segments. They may use it when devising special coverages for newly identified target groups.

Using computer-based communications, agents can link tightly to their companies, in the interest of smoother processing and lower costs. They can use small systems for independent analysis and pursuit of markets, at once enhancing their service and protecting their position. Direct marketers can use computers to assign incoming calls among telephone representatives as available or according to specialty. Then in an instant the whole file is open on the assigned representative's screen. It does not matter where on the planet the representative is sitting.[2]

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[2] So far, nobody has figured out how to apply to personal property-casualty insurance two information-based techniques that have greatly lowered costs elsewhere in finance. One is risk

Technology and Regulation

The present changes in information technology have shown in other contexts that they can lead to reduced costs and to the opening of new geographic markets and new kinds of service. Sometimes the change was to the advantage of the people already succeeding in the affected business. Sometimes the change favored other participants, even entirely new ones. When it happened in a regulated business, a big factor in determining who gained and lost was the position taken by government toward the new technology.

Insurance regulation, like other regulation, has two characteristics that tend to make it resist any new technology.

The first characteristic is a concern for borders and boundaries. They can be geographic, the limits of a government agency's territorial jurisdiction. State regulators know that border well. Borders can also be functional or substantive, defining the subject-matter of regulation. Bank and insurance regulators are testing the functional boundary between them right now. Beyond its geographical and functional borders, an agency cannot regulate. Yet any regulator knows that what happens just over the borders can undercut what he does within them.

The second characteristic is a tendency to be reactive. Regulation follows rather than leads change in the regulated activity. It has constituents in the regulated

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management and financing in commercial insurance. The other is securitization of standardized personal debt. Were those two techniques to come to personal property-casualty insurance, they would bring quite a saving. For example, if a block of homeowners business could be completely covered by a combination of risk retention and securitization techniques, it would require essentially no insurer capital to support it. Suppose a prudent insurer is levered to the extent of premiums' being twice capital, and suppose the insurer sets prices so as to earn a 15% return on that dedicated capital. Then every dollar of capital not used would justify a 7.5 cent reduction in premiums. To appreciate the magnitude of that saving, consider the effort and reward involved in managing down a company's expense ratio by 7½ points.

business. Some of them will feel threatened by change, particularly if it lets competitors in. Financial regulation is safety regulation, so it cultivates a conservative temperament. For those reasons, regulation will tend to resist the cost-cutting, price-cutting and border-crossing potential of information technology.

Yet the record of insurance regulation in adjusting to advances in information technology is not at all bad. Here are cases in point.

The biggest single adjustment was in rate making and rate regulation in property-casualty insurance. There are three general approaches to rating. One is to let the underwriter use his own judgment one risk at a time – the marine approach. A second is to set rates on the high side and then agree to charge the rates – the fire approach. The third is to use statistics on past losses to project future losses and then add expense and profit loadings – the casualty approach.

The casualty approach is the only one of the three that is information intensive. It has taken over more and more of the market, as information has become easier and cheaper to collect, the techniques for analyzing it have become more powerful, and markets have become more competitive. The regulators encouraged that movement over a seventy five year period, which was exactly the right response.[3] It put

[3] Which rating approach to use was the subject of bitter disagreement. It was not just technical. It went to how companies were set up and run and to their relations with agents and government. The S.E.U.A. antitrust case (1944) was a criminal indictment of a fire insurance rating board and its members. After the Supreme Court upheld the indictment, the McCarran-Ferguson Act (1945) partially exempted the industry from the anti-trust laws, conditioned on state regulation. The Act is the modern charter of state regulation, but preserving state regulation was a common objective and not an issue. The fight at the time was over how broadly to phrase the exemption from anti-trust. The NAIC sided with the casualty approach, and it prevailed. The final Act explicitly did not exempt any "act of boycott, coercion or intimidation". The quoted language came straight out of the S.E.U.A. indictment. Its effect was to outlaw the techniques necessary to enforce agreements on rates – the fire insurance approach – while leaving casualty rating alone.

regulation on the side of the nearly irresistible tendency of competitive markets to push prices into line with costs.

More recently regulation has been challenged three times to respond to changes in information technology. Its record has been spotty.

The first began just after the Second World War, as insurance companies sought to expand geographically and to diversify within and beyond insurance. Regulation responded over a twenty year period by permitting prudent adaptation. The steps extended from the multiple-line laws in 1948 through the holding company laws in 1970. Again that was the right response. An intelligently diversified insurer is more stable than a specialty insurer of equal quality. An insurer that is allowed to adapt to changing customer needs is more likely to be profitable and easier to regulate in other ways than one trapped in an anachronistic role and structure.

The second challenge to regulation was from the risk management movement and the unbundling of insurance products, both described earlier. Regulation has generally been slow to accommodate risk management. That is understandable in view of the inherent conservatism of regulation, its instinct to protect local constituents and its desire to preserve cross-subsidies within the insured population. In turn, the risk management movement has, by and large, avoided regulation. Its vehicles, from non-admitted companies and offshore captives to non-insurance substitutes for traditional insurance, have reflected a preference as well as a necessity to minimize involvement with the regulatory process.[4]

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[4] The employee benefits sector of health insurance has followed the same pattern. The savings were even more obvious and the solutions simpler. Regulators tend to favor community rating, the broadest of all cross-subsidies. Because health care costs in a large population of corporate employees are highly predictable, the larger employers have been able simply to retain the risk. As risk retention and managed care have drawn the healthier people out of the conventionally insured and regulated pool of

In life insurance, the regulatory response to changes based on information technology has been better than it was in property-casualty risk management. The unbundling of life insurance products has been done with regulatory supervision and frequently cooperation. Variable life insurance and variable annuities were almost joint creations of industry and government, in recognition that needs and capabilities were changing.

Those and other "interest sensitive" life insurance products are remaking many aspects of the life industry. It has not all been graceful, but the new products have remained within the industry.[5] They are sold by life insurance companies in the regulated market. They have, however, served as points of entry for dreaded competitors.[6]

The third challenge to insurance regulation posed by information technology has been in regulation for solvency. Improvements in information have revealed cross-subsidies, inefficiencies and unusual profits in products, operations and market segments, so competition could go after them. Better information has also enabled risk management to reduce the demand for insurance. Those developments are behind the

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risks, that pool has become increasingly residual, bringing an upward spiral of costs and prices and insoluble problems for regulators on the merits and politically.

[5] We do not mean to imply that regulatory wisdom has been the only reason that interest-sensitive products have stayed within the life insurance industry. The exemption from current income tax for the compound interest on the investment element of a life insurance product (the "tax-free inside build-up") has been a powerful incentive for the life industry to retain life contingencies in, and hence the life insurance label on, its new investment-oriented offerings.

[6] Because variable life insurance and variable annuities are by law both securities and insurance products, securities firms have been in the variable life and annuity business, and life insurers and agents have been in that part of the securities business, from the beginning. Commercial banks came later and have been prohibited from selling insurance (variable or not) in twenty states. Yet banks already account for 25% of U.S. individual annuity premiums. (Source: Association of Banks-In-Insurance) As described later in this report, the U.S. Supreme Court recently removed barriers to bank sales of annuities from offices in towns of less than 5,000 people.

fierce price and product competition which has been the natural condition in the life, health and property-casualty markets since the 1970s.

The competition led to a wave of insolvencies in the 1980s and early 1990s. The regulators had two responses. One was to adopt more sophisticated techniques, called "Risk Based Capital", for evaluating insurer financial condition[7]. The response did not, however, go beyond strengthening familiar techniques.[8] The other response was to facilitate "restructurings" to rescue failing companies by walling off their largest claims from the continuing enterprise. The ultimate outcomes of the restructurings are not yet in, but they have been widely criticized for putting the interests of the company ahead of those of the policyholders.

Conclusions about Technology and Insurance

From the beginning of this century until today, changes in information technology have driven down the overhead and capital costs of insurance and have

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[7] The new rules and procedures for Risk Based Capital could not have been implemented without the abilities of computer-based financial analysis. Insurance regulators, like the insurance industry, have been avid users of computers.

[8] Government regulation to deal with the problem of insurer insolvency is, like all regulation, organized around an explicit or implicit intellectual model, or paradigm, of how the problem comes about. In the nineteenth century, state regulators saw fire insurance company insolvencies as occurring on such a large scale because the companies competed away the safety margin in their prices, so that it was not there to absorb the losses from a big city fire. Their answer, as described in this report, was to help the industry enforce price-fixing agreements. Since the 1950s, as competition has intensified in both life and property-casualty insurance, the prevailing model or paradigm of insolvency has been a weak company's gradual competitive decline while the regulators fail to take action to save it. Risk Based Capital is the NAIC's latest elaboration of the techniques for detecting decline early and forcing regulators to act. While the paradigm of competitive decline continues to explain many insolvencies, it is likely that the years ahead will bring more insolvencies following a catastrophe to which particular companies were unusually exposed. Company bankruptcies following property catastrophes (such as hurricanes and earthquakes), liability catastrophes (such as the federal pollution liability statutes) and investment catastrophes (such as the junk bond and real estate collapses) suggest that the new paradigm is already here and that the NAIC should, therefore, have gone beyond elaborating the old one.

sharpened its pricing of exposures to loss. That is natural for a business as saturated with information as insurance. The changes taking place today will surely lead to even lower costs and to opening new markets geographically and functionally.

In this part of the report, we have seen our first evidence that regulation does nobody a favor by obstructing changes like those taking place today. We will see more. A promising place to look is in an aspect of insurance absolutely certain to be affected. The area is distribution, the agency function. The relevant regulation is the licensing of insurance agents.

Part Two: The Licensing of Insurance Agents

This part of the report looks at how and why agents[9] are licensed. Licensing agents is the oldest aspect of state insurance regulation, having begun early in the nineteenth century. The reasons for it are to be found in the insurance business of that era and in the public policy of that era. As the business evolved, the reasons for licensure did too.

The overall conclusion of this part is that the historical reasons for licensure do not relate to the insurance markets of today. There are two keys. One is that, in the beginning, the agency business was personal and so licensure was personal. The other is that, in the beginning, the local agent was the only part of the insurance business that states could get jurisdiction over and so licensure was local.

The Mechanics of Licensure

We will discuss at length the reasons why states have licensed agents over the years. But first the mechanics.

Licensing gives power to the state. Whatever the reasons or public goals the states were pursuing at any given time, licensing has been a useful tool for attaining them. Licensing gives the state significant power over the agent. It enables the state to

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[9] The nomenclature of insurance is often confusing, and the word "agent" is a good example. In this report, we will follow the usage of the business. When we speak of a life insurance agent or a property-casualty agent, we will mean someone who traditionally and usually transacts insurance on behalf of an insurance company. Thus the term will include, in property-casualty, independent agents, exclusive agents and telephone representatives in direct response insurance companies. In life, it will include career agents and also brokers in the life insurance sense of representing several companies. Left out by that definition are insurance brokers, life and property-casualty, who are acting primarily for the buyer or policyholder.

control entry to the agency side of the business. It enables the state to keep track of who is in the business. It enables the state to punish agents by suspending or revoking the license.

Licensing gives practitioners a badge of authority and approval. A license is required of anyone who solicits or transacts insurance on behalf of an insurance company.[10] Some states go further with statutes called "resident agent" or "countersignature" laws. They require that every placement of insurance on a risk located in the state include in the transaction an agent residing in the state.

Licensing works at the personal level. The license is given to each individual who performs the function. The agency or brokerage[11] organization in which the individual works may or may not also have to be licensed, but the main requirement is personal.

Even so cursory a survey brings questions naturally to mind. Since most insurance agency work these days is done by organizations and not by sole proprietorships, one may ask about the personal emphasis. Since so many client businesses are multi-state, one may ask about the resident agent requirement. The answers to those and many other questions about licensure are historical. They are to

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[10] Statutory language differs widely among states. Some aspects of the applicability of the laws are left open or unclear. The NAIC Agents and Brokers Licensing Model Act speaks of anyone "appointed by an insurer to solicit applications…or to negotiate a policy…." With a few exceptions for direct dealing between principals (typically industrial insureds buying from non-admitted insurers) and for purely direct mail, the practical effect of the licensing requirement is also to require the presence of an agent in every sale. The agent does not, however, have to be independent of the principals.

[11] Twenty seven states recognize brokers as a separate category of intermediary. In those states, the presence of either an agent or broker will satisfy the requirement. In the other 23 states, an "agent" in the usual and narrower sense is required. Multi-state organizations that are commonly thought of as brokers are, in fact, licensed as agents in those states.

be found in the changing purposes of licensure and particularly in the role of agents in the very early days of the American insurance business.[12]

Early Reasons for Licensure

Agent licensing began early in the nineteenth century. The structure of the insurance business and the place of agents in it were far different from today.

In those days the huge expanse of land was only sparsely settled. Insurance companies were clustered on the east coast. Transportation and communication across the great distances were slow, expensive and unreliable. One consequence was that insurance companies doing business beyond their home offices had no choice but to delegate a lot of authority to people on the scene – their local agents. Another consequence was that, in smaller communities, there was not enough insurance activity to make a full-time job out of being an agent. But it could be a profitable sideline for a local merchant or attorney. So an insurance agency in those days was not an organization. It was one person.[13]

The very first use of the agent licensing power was to make sure the state collected its rightful premium taxes when local buildings were insured by distant insurance companies.

[12] The American (and Canadian) historical experience gave rise to a different system of regulating insurance intermediaries than found in Europe. Belgium, Germany, Spain, Switzerland and the United Kingdom traditionally did not license or regulate agents. The European Community's proposed regulations for harmonizing national insurance rules are changing the situation.

[13] The personal nature of insurance agency was not at all unusual at that time. Most making and selling of goods was done by small, local, family businesses. The rise of great corporations, starting with railroads and extending to manufacturing and distribution, still lay decades ahead.

In the 1820s, several states began to license agents of out-of-state ("foreign") insurance companies. The state required the agent to file written proof of his authority to represent the foreign company and a sworn statement of its financial condition. The purpose was to collect premium taxes on the in-state business of the out-of-state companies.[14] Those taxes were at higher rates than the taxes on domestic companies. Issuing the agent's license was contingent on his remitting the premium taxes owed by his foreign company. The reason for focusing on the agent was that he was there and the foreign insurance company was not.[15]

As agent licensing spread among the states, collecting taxes from foreign insurance companies remained the dominant purpose. Since states had no difficulty gaining access to locally-domiciled ("domestic") insurance companies to collect taxes, they did not need to use the agents as collection points and hence did not bother to license the domestic companies' agents.

States began to license agents of domestic, as well as of foreign, companies when they needed to. That was after the states embraced a new reason for licensure besides tax collection. The new reason was to help all insurance companies, domestic and foreign alike, gain control over price competition. It happened in both life and property insurance, and it came about like this.

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[14] Another consequence was to make the agent available for service of process in litigation against the foreign company. But tax collection was the driving purpose.

[15] The pattern recurred in dealing with non-admitted or surplus lines markets. Just before the turn of the century, states reconciled their desire to regulate insurance companies for solvency with their desire to let their constituents meet their need for more insurance than the licensed companies would sell. The reconciliation involved permitting unlicensed insurers to write when the licensed ones refused, so long as their local presence (the "surplus lines broker") was specially licensed, would monitor the company's financial condition and would collect the state's tax on its premiums.

Life insurance boomed in the last half of the nineteenth century. It was the main way for wage-earning families to save and to provide for the early death of the breadwinner. The business was very competitive. It was a race for growth among three giant companies based in New York, appropriately known as "the racers."

Competition for sales took the form of bidding up agent commissions. Not surprisingly, very high commissions in the first year a policy was in force proved to be a strong incentive for new sales. First-year commissions rose until they exceeded the premium, so a company's only hope of profit was for the customer to stay with it for several years, frequently as many as fifteen or twenty. Alert agents learned to give back (or "rebate") to the customer part of the first-year commission to close the sale. Alert customers learned to make the rounds of companies, getting a rebate every year. Such a customer, called a "rounder", could get virtually free insurance, and his circle of agent friends could get first-year commissions every year.

Life insurance companies and state regulators quickly figured out that in a market of rebaters and rounders, the companies would go broke. In 1889 New York passed a law forbidding commission rebates. The sanction was for the insurance department to kick out of the business any agent guilty of rebating. That meant making a license necessary and giving the department the power to revoke it. The dominant companies were domiciled in New York, and the state's anti-rebating law of 1889 was the first to require agents of domestic companies to be licensed.

But throughout the period, the life insurance business was only loosely regulated. Its rudimentary accounting principles did not distinguish between retained profits and the accumulating premiums held for future benefits (now called the "policy reserve"). Company managements tended to treat all the money as the company's money and sometimes as their own.

The industry was growing head over heels. The three New York racers had become the largest financial institutions in the world. But the cost of growth was out of control. Managements worried about the long-term problem, but day-by-day they ignored it or tried somehow to grow their way out.

Outside help was needed, and it came in the form of the legislative reaction to a scandal.[16] The New York state legislature convened a committee in 1905 to investigate abuses in the business. Its revelations and the ensuing laws molded the modern American life insurance industry.[17] Among its recommendations were controls on commissions for life insurance agents. It proposed sanctions for rebating and for "twisting" customers from one company to another to get repeated first-year commission.[18] All were backed by the insurance department's power to revoke the licenses of insurance agents.

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[16] The largest company, The Equitable, threw a birthday party for the son of its founder. The party cost several million of today's dollars. The New York City press of Pulitzer and Hearst had a field day. That got the public's attention. The party came during an epic battle between Wall Street's two most famous investment bankers, J.P. Morgan and Jacob Schiff of Kuhn, Loeb, for control of that same company. They wanted to use its immense, largely unregulated wealth for their industrial mergers. That put on the table some big questions of public policy toward industry and finance. The episode was thus perfect at all levels. It could entertain and instruct everyone from the social voyeur to the policy scholar.

[17] The committee was called the Armstrong Committee after its chairman. Future Governor and nearly President Charles Evans Hughes was its counsel. Beside restraining asset growth, agent compensation, insider dealing and corporate governance, the Armstrong legislation also prevented life insurance companies from controlling industrial firms and banks and from holding large amounts of other companies' stock. In those respects, the Armstrong reforms helped prevent life insurers from becoming the American equivalent of the European and Japanese universal banks, a development which was well along in this country at the time.

[18] The Armstrong limitations directly affected only companies domiciled in New York and companies domiciled elsewhere which were licensed there. But New York required not just compliance in the New York operations of those companies but also "substantial compliance" everywhere. The problem of price and commission warfare was regarded as serious enough that the industry and the other states acquiesced for decades in that striking example of interstate imperialism.

The fire insurance business had an even longer history of trouble with unrestrained price competition than life insurance did. Fire insurance was especially useful and especially difficult to write in cities and towns. Buildings there could catch fire from each other and burn the whole town down. Big urban fires wiped out a lot of fire insurers in the nineteenth century, depriving individual owners and whole communities of the money to rebuild. The only way anyone could think of to head off so damaging a result was to let the fire insurers accumulate profits against the day of a catastrophic fire.

But the business was hard to rein in. Agents had plenty of underwriting and pricing authority. They would do whatever they had to do to get and hold business. So the leaders of the industry looked for ways to restrain price competition. The way they chose was for everybody to agree to charge the same rate. The agreements were enforced by local boards of agents. Anybody who cheated would be run out of the business, boycotted by all the others.

As in life insurance, the price-maintenance agreements among fire insurance companies and their agents had a record of falling apart after a short time. There was too much incentive to cheat to get business. Again, help came from a government investigative committee.[19] After examining anti-trust approaches, then popular for the rest of the economy, it rejected them in the interest of solvency. The committee endorsed the industry's price-fixing efforts. Other states followed.

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[19] This committee of the New York legislature was called the Merritt Committee after its chairman. Leading to its creation were both the problems in life insurance, recently exposed by the Armstrong Committee, and the problems in fire insurance rate-making, recently revealed by the San Francisco earthquake and fire, which wiped out numerous fire insurers. After a careful review of the alternative ways of making and regulating fire insurance rates, the Merritt report (1911) found that price competition was destructive of company solvency and that anti-trust rules applied to fire insurance (by state "anti-compact" laws prevalent in the middle west) only made it worse. The report concluded that the public interest called for a system of rates made in concert and agreed to by the whole industry. The system would be supervised by the insurance department, which would help enforce the rates.

The fire insurance cartel or bureau system depended on everybody's resisting the economic incentive to cheat on the agreed rate. Experience showed that voluntary compliance would not work for long. Enforcement was needed. Leaders of the fire insurance bureaus set up a pervasive and ruthless apparatus for enforcing conformity. The state had a vital role in it – to police against cheating.[20] In that task, the states' most useful tool was the penalty of license revocation. For most states, the licensing power over agents was the only real power over the insurance market they had.[21]

In those facts about the nineteenth century insurance business are to be found all of the early reasons for licensing agents. The states licensed individual agents rather than agency organizations because the agency business was done by individuals. The states wanted power over the holders of those licenses.

The first of the two early purposes of licensing agents – collecting premium taxes – is still a public objective of the states, but agents are a far less significant part of it.[22] The second purpose – restraining competition – is no longer a public objective at all. But the original purposes of agent licensure are not the only possible ones.

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[20] Those origins may explain two features of the first rate regulatory laws that are otherwise puzzling. The first law, New York's of 1911, regulated the bureaus but not the rates. The likely reason is that the bureaus took care of the rates. Amendments soon thereafter provided that rates not be "unfairly discriminatory". That probably referred to cutting the bureau rate to do the policyholder a favor. The only surviving illustration is of deviating from the bureau's printshop rate under pressure from a newspaper publisher. Strangely to the modern eye, the early laws did not prohibit rates that were excessive or inadequate. The likely reason is that general rate levels were the bureau's responsibility. The structure of the early fire insurance rating laws resembles the two-tier or indirect structure of regulation exemplified by the S.E.C. and the stock exchanges today.

[21] Disciplining a company was impractical. The country was generally short of insuring capital, especially in the states of the interior and the west. For a state to act on a company's license would have been self-defeating.

[22] Today, almost all premium taxes are collected directly from licensed insurance companies. The agent or broker is the collection point for taxes on premiums paid to nonadmitted insurers, that is, insurers which are not licensed to do business in the state. The agent also plays a role in premium tax

Later Reasons for Licensure

Starting after the First World War, two new reasons emerged for licensing agents. One was to raise the standards of professional quality. The other was to protect agents from competition. The two were usually considered together, and support for both came mainly from agents and their trade associations.

The early reasons for licensure called for state power over agents. The state needed the ability to capture premium tax at the agent's office. It needed the threat of license revocation to keep agents from breaking agreements on rates and commissions. But jurisdiction and leverage were enough. For purposes of taxes and penalties it did not matter who held the license, so long as the state could take it away.

Then around the time of the First World War, agents and their associations began to press for "qualification laws". The license should not be issued to just anybody who applied. It should only go to someone who was "suitable" and would practice "in good faith".[23]

By then many agents could make insurance a full-time, independent occupation. They sought to keep out of the field those who did not. They sought to exclude from licensure people who were agents only part time and people with other jobs. They tried to disqualify people affiliated with insurance companies. They tried to stop insurance companies from opening branch offices that took over functions theretofore performed by "policy writing" agents. All those exclusions were sought for the avowed purpose of raising professional standards.

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collection in the few states which still audit agents' books to ensure that companies are correctly reporting the premiums they receive on local risks. See footnote 25 following.

From the records of the period it is hard to isolate the original motives behind efforts to use licensure to set qualifications and disqualifications for agents. In all probability, laudable desires for professional betterment were inextricably mixed with understandable desires to keep competitors at bay.

Since then, agent organizations have pressed the states to enforce ever higher standards for licensing. Agents, companies and regulators found it easy to agree that high competence and character were desirable attributes. More difficult and divisive was whether to use the licensing power to require them above some minimum level.

The agent associations were more successful in securing enactments that required every policy on a risk located in the state to be countersigned by an agent residing there. Some of those "resident agent" or "countersignature" laws also mandated that commission to be paid to the resident agent. Some even specified the percentage.[24] The effect of those laws was that a policy covering a large corporation's properties and operations nationwide would have to be countersigned by, and commission paid to, many agents around the country.

The resident agent laws appeared during a time when, in many parts of the economy other than insurance, local business interests were fighting the invasion of

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[23] Written examinations came much later. They were not commonly required until the 1950s. Now all states have written examinations. Most also require class work and some require continuing education.

[24] Resident agent laws provided yet another occasion for a fight between the fire and casualty segments of the property-casualty industry. The fire insurance industry was formed in the mid-nineteenth century. Its emphasis was local as befitted the transportation and communication of the time. Fire agents were usually appointed for limited territories within a single state. The casualty insurance industry emerged later, with workers compensation and automobile insurance in the early twentieth century. With better transportation and communication at their disposal, casualty companies often appointed general agents for large territories spanning more than one state. The fire agents tried to stop that development with resident agent laws. Over this issue, the casualty agents split off from the trade association of fire agents and formed their own.

local markets by national business firms. As multi-state manufacturing and distribution corporations replaced local artisans and purveyors, the new corporations tried to buy their insurance on a similarly multi-state basis. They used brokers in their headquarters cities to place the whole account.

The resident agent laws were in part a specific defense against that practice. In part they were a reaction to the insurance business's own early moves toward multi-state operation. In part they were manifestations in insurance of a more generalized resentment in the countryside of the 1920s against the national corporations that seemed to be assaulting a whole way of life.

Motives may have been mixed throughout the efforts to use licensing to set higher professional standards for agents. But motives behind the resident agent laws were unmistakable. They were to keep big outsiders out of small town insurance markets. Resident agent laws were the first avowedly protectionist use of the licensing power.

Evaluating the resident agent laws as burden or benefit is next to impossible.[25] No doubt they cost consumers and workers something, by raising overhead costs for businesses located in the enacting state. But we do not know whether they ever tipped the balance against the siting of a plant or a job.

Our best judgment is that the resident agent laws have not had much practical effect in protecting agents either. As communications improved, it became easier for

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[25] Evaluation is made even harder by the fact that two other justifications are sometimes advanced that are not just protectionist. One is that only by auditing a resident agent's books can a small state verify the premium tax due it on a multi-state account based in a larger state. The second is that requiring resident agents improves the availability of insurance in small states in times of panic in the property-casualty markets, when insurer managements are apt to over-generalize and hence to attribute to small states their woes in nearby larger ones. While we doubt those two factors are very significant on the merits, any political appeal to state revenues and insurance availability is not to be trifled with.

large clients and their brokers to comply nominally or to get coverage in the non-admitted market. The growth of risk management and the alternative market are making it easier still. Once the insurance account is governed by a risk management mindset, the local agent is never going to see it again. The same is true of the naturally direct placements of insurance – the direct response companies, fraternals, cooperatives and self-insurance plans. They have either complied by licensing their employees or have had the political muscle to obtain exemption at the state or federal level. Whatever the usefulness of resident agent laws to protect local agent interests in the distant past, it is quite possible that today those laws are more of a burden on conventional agents than on their broker, banker, risk manager and other competitors.[26]

Both of the recent objectives of licensure – professionalism and protection – make the most sense in an agency world of individuals and small proprietors. Professionalism is an individual achievement.[27] Protecting local insurance agents began

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[26] That ironic outcome is particularly likely where resident agent laws have become caught up in battles among states involving "retaliatory laws." Detailed discussion is beyond the scope of this report, but briefly the retaliatory laws are efforts sponsored by insurance company associations a half century ago to deter states from raising premium taxes. The laws provide that if State X taxes or otherwise burdens companies domiciled in State Y (on their business in X) more than State Y burdens companies based in X, then Y must raise the burdens on those X-based companies to the same level. The laws presuppose that states will go to bat for their locally-domiciled, multi-state insurance companies. That political logic can work for taxes, but it has no force where (as with resident agent laws) the precise point is to use the law to deter the multi-state form of organization. So when one state tightens its resident agent law, it merely sets off an escalating spiral of burdens from other states, and the first state's agents get their local protection at a very high competitive price.

[27] Continuing education for agents and others in the insurance business is now widely available, with plenty of competitive incentive to pursue it. Over 44,000 people have now received the CPCU (property-casualty) professional designation, and 80,000 have received the CLU (life) designation. Both require special course work and examination administered by professional societies and specialized colleges. (Source: American Institute for Chartered Property-Casualty Underwriters, The American College)

as part of general resistance to the encroachment on local enterprises by big business. It is most persuasive when its beneficiaries are small and personal businesses.[28]

Conclusions about Agent Licensure

The states began licensing agents to get leverage over them and, through them, over the insurance business. The states wanted jurisdiction at first so as to tax the business, using its only local presence. Later the states used their power over agents to help enforce rules and agreements limiting price competition, in the interest of company solvency. Later yet, the states used licensure to set professional standards and to protect local agents against outsiders.

Every step in that succession of public policy bases for agent licensing makes the most sense for the agency business in its early configuration – local sole proprietorships doing most of what mattered in the insurance business.

Needless to say, the present system of distributing insurance is far different. The agency function is done by a variety of organizations, from companies using employees, to exclusive agents, to independent agencies and brokerages of all sizes. The organizations allocate functions in many ways. Many do business in all lines of insurance. Most trade across state borders, and many trade nationally. Even in the world of small independent agents, the relevant unit has changed from the agent to the agency.

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[28] Whereas nearly all insurance agencies in the mid-nineteenth century were personally-owned, sole proprietorships, nearly all premium today which is written by agencies at all is written by agency companies which are corporations and which have several, and sometimes many, employees. For example, in property-casualty insurance, over 90% of premiums written by agencies are written by agency corporations or agencies which have at least five employees. The percentages would be even greater if brokerage corporations were included in the totals. (Source: Independent Insurance Agents of America)

For all those reasons, agent licensing may interfere with the competitive deployment of recent advances in information technology. If so, there arises the danger that what the states do will appear archaic and ignoble – too local, too personal, too repetitive and too protectionist. The next part of this report explores the possible conflict and its likely outcome.

Part Three: The Collision of Technology and Licensing

We cannot predict exactly how information technology will affect insurance in the future. The lines of development will follow many influences other than the economics and convenience of the insurance business. Technology itself may advance much faster than the insurance business can make use of it.

In such a situation, the most robust strategy is probably one that does not depend on perfect foresight. It is to position one's institution – business or regulator – so as to be able to move with the flow wherever it goes. In such a situation, it may also be possible to use even an indistinct vision of the future as the basis for workable decisions and plans.

That is the situation with respect to technology and licensing. Where the route of development of information technology intersects the barrier of agent licensing, we can see well enough what is coming to make policy decisions.

The Movement of Technology

A good way to start is to consider the implications of a few advances in information technology we already know a lot about.

For one, technology is making it easier and cheaper to gather and analyze a lot of facts about prospective customers. We are seeing its effects in other financial services and in the marketing of consumer goods. Gathering and analyzing facts is the essence of insurance underwriting. Today, underwriting can be done anywhere the facts are, which may be far from the physical situs of the risk.

Another known advance is that the customers of insurance companies and agents are becoming more adept at working with the input and communication devices that are part of computer-based systems. The TV remote, the pocket calculator and the automated teller machine have trained everyone to be a data input clerk. Customers will be able to perform many data management functions themselves and will be less docile clients of others who perform them.

One last, known development is that it has become easy, cheap and almost invisible to reach out great distances for communication and sales. As consumers become more accustomed to shopping by telephone, using e-mail at work and reading newspapers and doing research on the Internet, it may matter less to shake an agent's hand. Servicing policyholders by changing coverages and answering questions can be done from anywhere to anywhere. The essence of good service is not propinquity but timely and sympathetic response based on accurate information.

The preceding examples are of categories of technological advance we are familiar with. Respectively they involve data analysis, data input and data communication. They describe the core of any information technology. We live comfortably with such changes every day.

That does not mean, however, that we know for sure how any of the changes, even the most familiar ones, will settle in eventually, in insurance or any other field of commerce. Commercial rewards are apt to migrate toward the gathering places of the critical information and the techniques for handling it. But where that will be is not foreordained. It may be an insurance company or an agency or a managing general agency.

One thing the recent developments have done is to make information far more accessible and less expensive than it used to be. Information can be used instead of

capital in information-based businesses. While it is true that the computers and other equipment for managing risk-related information cost money, the essential point is that they may nonetheless cost much less than the capital needed to carry risk in an old and uninformed way. For similar reasons, barriers of functional specialty and geographic location will matter less in the future than in the past. The mystery of market niches, and with it their margins of profit, tends to fade under the light of better information.

Those big changes may be clear and nearly certain prospects at the most abstract and general level. But what they may mean for individual organizations is anything but clear. For technology faces in many ways at once. It carries the contradictory seeds both of centralization and decentralization, of scale economies and the possibility of doing more while staying small. It is capable of both helping the insurance business become more efficient and responsive and helping outsiders come into the field and either sell conventional insurance cheaper or deconstruct and replace it. If technology confers a competitive advantage, then the technology will not be neglected. The question is who will get it to market first.

For these questions of who may win out, and particularly their meaning for insurance agents of various kinds, we should turn from how the technology works to how the agency function works in insurance.

The Economics of Intermediaries

The function of any market intermediary, including insurance agents, is to bring buyer and seller together. The intermediary's economic justification is that he charges less for his services than it would have cost the buyer and seller to get together directly. As long as that is true, the intermediary is fulfilling a valuable function – lowering the total cost of the transaction to the buyer and seller.

Bringing buyer and seller together involves searching the market, gathering information about needs and available services and dispensing advice. Intermediation is a process of gathering, processing and communicating information. Any change in the power and price of techniques for handling information goes right to the heart of what an intermediary does. Any such change has the potential of working as a resource or as a competitor or as both.

By way of illustration, the foregoing analysis can be used to explain the gradual decline of the market share of independent agents in personal automobile insurance. As the principal sellers became widely identified, the products standardized and the market better informed generally, the service of choosing among insurance companies to insure a particular motorist became simpler and simpler. As agents performed fewer of the old functions, their compensation went down. Prevailing commissions for independent agents in personal auto have declined by more than half during the past 50 years.

That decline felt plenty fast if you were an independent agent. But for the market it may not have been fast enough. Two distribution systems with far lower costs – exclusive agency and direct response – have grown dramatically.[29]

Life insurance has experienced a parallel development. Traditionally the highest skill in the life insurance field was an agency skill. It was selling level premium, cash-value life insurance to customers one at a time. The most effective method of

[29] One reason for the lower costs of direct response and exclusive agency is that they can build much of their distribution capability in the form of fixed investments in information technology. Examples are the purchase of computing and communications equipment and the cost of training salaried staff in its use. As more transactions and more premium volume are handled by that fixed-cost capability, the distribution cost of each transaction and of each dollar of premium goes down. Independent agents, on the other hand, perform the same functions for a commission expressed as a percentage of premium, so the insurance company's distribution cost per dollar of premium stays constant and its dollar cost per transaction actually goes up as premiums go up.

distribution was the “career agent”, trained largely at company expense, writing business for that company alone and compensated with high first-year commissions.

Today that is no longer true, and the life insurance industry has not fully adapted to the new reality. The average career agent will never make a good living from one company. Nor will the company ever earn back from his career of sales the amount it invests in training him. The causes are many, but the message is clear. The old product with the old distribution cannot make it anymore.

Life insurance and annuities today compete against many other investment products with annual expenses as low as one percent of the invested amount. People heading into retirement on less generous corporate pensions do not need to be sold hard on supplemental annuities the way they once needed to be sold life insurance. Nor do they need the market search and educational functions of an intermediary the way their parents did. To the extent they are willing to bear investment risk without a life insurance company’s guarantees, they will be less disposed to pay a company for the use of the capital needed to support such guarantees.

What the life insurance industry is going to do about this predicament in the long run is not clear. Ignoring it or applying short-term fixes has been unavailing or worse. In the 1980s and early 1990s, some companies tried giving a better bargain by guaranteeing policyholders high interest rates and easy withdrawal privileges, and then not charging for the corresponding risks the company was taking. Several went broke.[30] Some agents tried selling one product, which carried a higher commission, in the guise of another product which appealed more to customers. Several got

[30] Examples are Baldwin-United (1984), Executive Life (1992), First Capital Life (1992), Guarantee Security Life (1992) and Mutual Benefit Life (1993).

disciplined and sued, along with the companies which might have supervised them better.

A conclusion emerges from our examination of those ongoing efforts to adapt. It is that as information technology changes insurance, two broad alternative business strategies open before the community of intermediaries. Both are good strategies.

One strategy is to encourage the simplification of the intermediary role and to concentrate on reducing costs to customers. The agent accepts lower compensation per sale and concentrates on cutting his own costs and on building sales volume based on the lower prices to consumers. In economic terms, that was the strategy of exclusive agency in personal property-casualty insurance.

The second strategy is the opposite of the first. The intermediary redefines his role, partly by taking over functions from the two principals. He is likely to assume responsibility for managing the technology, bringing the savings to customers and covering his own compensation out of the savings. That was the strategy of the commercial insurance brokers in the risk management movement in property-casualty and health insurance.[31]

Both of the two successful strategies involve embracing the cost savings and service enhancements made possible by the technology. The approach that failed was to act as though nothing had happened or to try to obstruct the translation of

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[31] Both strategies succeeded hugely in market share. Exclusive agency now accounts for over half of personal property-casualty premiums. (Source: A. M. Best Company, *Aggregates & Averages*) The ten largest commercial brokers, those with over $150 million of U.S. revenues, place more than half of the country's commercial property-casualty premiums and their share of risk management fee income is even larger. (Source: *Business Insurance*) Although no good survey of agent and broker personal income is publicly available, anecdotal evidence suggests that the relative incomes of the agents in each market segment reflect the strategic successes – both the exclusive agents and the big brokers have done very well.

technological advance into cost saving for customers and competitive advantage for sellers. The segments of the company and agent communities that most often reacted that way have been the big economic losers in recent years.[32]

The preceding tales are still unfolding, and there is much we do not know about how they will play out. Yet they show that we can discern a lot about so big a change even from the midst of it and even before we can know the whole story. At some such midpoint we may know enough to make intelligent policy. We may know it early enough to make timely policy. The preceding stories strongly suggest we are at such a point for making policy regarding agents and technology.

Evidence from the real world of business is not, however, limited to ongoing and hence incomplete episodes like those just recounted. The real world also offers instructive episodes which are fully complete and on which the book has long since been closed. They point to the same conclusion about agents and technology – the conclusion that agents are better off going with it than standing against it. Two of them were so significant that they have become part of our shared background. They happened so long ago that we risk forgetting their lessons.

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[32] That is not to criticize a defensive posture or to say aggressive adjustment would have been easy or, in some instances, even possible. But it is still a fact. Examples include the following. In workers compensation, the traditional product and rating plans have not been able to compete with risk retention and loss-sensitive rating. As the regulators and much of the industry stood by traditional approaches, over half of the business went to self-insurance and the alternative market and the remainder became increasingly residual and subject to chronic rate inadequacy. In personal property-casualty, independent agents led the resistance to group marketing, one of their few possibilities for matching the scale and processing economies of direct writers. In life insurance, adherence to cash-value life insurance, when the market called for annuities, and to front-end loaded commissions, when competition came from lower cost intermediaries, has cost the industry in profit and reputation.

Two Examples from the Past

The first of the two past episodes was the beginning of exclusive agency and direct distribution in property-casualty insurance. They emerged early in the twentieth century with automobile and workers compensation insurance. Up till then, property-casualty insurance was almost entirely fire insurance. It was sold through independent agents. Rating and underwriting were the subject of agreements among competitors.[33]

When workers compensation came along just after the turn of the century, it called for a lot of accident loss data because it was closely tied to efforts to improve industrial safety. The established fire insurance companies were not set up for that, either in their ability to gather information or in their beliefs about good insurance practice. When automobile insurance began, the fire insurance companies naturally applied to it the very broad rating categories from the fire tradition.

To buyers of workers compensation and auto insurance, the fire insurance companies appeared unenthusiastic, rigid and high priced. Dissatisfied applicants formed new companies. Because they were close to their customers to start with, those companies did not need independent agents.

So began the exclusive agency and direct response companies. They originated with customer groups neglected by the fire insurance establishment. They could not have succeeded without the great advances of the day in communications technology – the postal service, telegraph and telephone.

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[33] The story of the fire insurance cartel system is recounted above in the second part of this report. In brief, it is this. The fire insurance business was extremely vulnerable to price wars. So the industry sponsored agreements among all companies and agents on rates and forms. Policy forms were standard and covered one peril (e.g., fire, wind, water) each. Rates were uniform for broad classes of risk. There were few concessions for size or favorable loss experience. Deviation was punished by exclusion from the business. States supported the system, in the interest of company solvency.

A crucial series of events that solidified the lead of the exclusive agency and direct response companies in personal insurance came in the 1950s, with the early automation of bookkeeping, typing and mailing. The technology enabled companies to take over the billing function traditionally performed by agents. The companies could do it cheaper than the agents could. The early equipment was big and expensive, but most of its cost was fixed. Pushing a larger and larger workload through the fixed facility caused unit costs to go down.

Independent agents saw the surrender of their billing function as a loss of independence, as indeed it was. They resisted the shift for fifteen years, switching business away from companies that tried to force direct billing upon them. During that time the exclusive agency companies implemented the shift, dropped prices to reflect the reduced costs, and took yet more of the market.

The second long-settled, illustrative episode is from the same time period as the emergence of exclusive agency and direct response – around the First World War. Fire insurance was still by far the main kind of property insurance and the fire system of agreeing on rates was at its apogee. That system operated through a network of local agreements enforced by agents and company field offices.

At that same time came the rapid development of national business corporations in the United States. Following the earlier path of giants in railroading, oil, meat packing and steel, manufacturers and distributors of many kinds found that the technologies of the railroad, telegraph and telephone made it possible to coordinate the activities of a far-flung enterprise. With facilities in many states, goods constantly on the move and inventories at any one location fluctuating from day to day, the new national corporations wanted property insurance on a similarly national and flexible basis.

The fire insurance industry, mighty as it was, could only offer a stack of single-location, fixed-value policies on an unvarying, board-approved, named-peril form, written by different local agents often with different insurance companies. Nationwide corporations were a profitable and growing class of customers for fire insurers. For years the leaders of the fire insurance industry struggled against the constraints of their own cartel to meet those customers' needs. They never did.

Instead the property insurance needs of the national corporations were met by an extension of the ocean marine line of insurance. Traditionally unregulated by the American states because oceangoing vessels were outside the borders of any state, marine insurance, or inland marine as this variant came to be called, was free of bureau and regulatory constraints. Inland marine business came not from agents around the country but from brokers in big cities like New York and San Francisco who would place a national corporation's whole account in a single transaction.

Local agents tried to protect their commissions by getting legislatures to pass resident agent or countersignature laws, but they lost out in the long run. At most the laws forced the controlling brokers to split their commission with local agents for the formality of a countersignature. If really provoked, the brokers were apt to turn to markets which were not constrained by what seemed to them protectionist and wasteful regulation -- the nonadmitted market led by Lloyd's of London.[34]

Today's major industrial coverages of All-Risk Property, Manufacturers Output and Difference in Conditions all derive from inland marine innovations of that time. That business forms the core of the portfolios of the major national brokers.

[34] It is no coincidence that the time of most rapid growth of the national brokers – after the Second World War – was also the period of Lloyd's greatest penetration of the U.S. general liability market behind a first-layer excess policy (called the "umbrella") particularly attractive to large corporations.

Those two episodes from the fairly distant past, like the ones we described that are still in progress, turned on developments in information technology. They illustrate how such developments lead to a reshuffling of competitive advantages among the competing kinds of intermediary. They also illustrate how much a quick initial response can foreordain the long-term outcome. The exclusive agency writers never gave up their lead. Neither did the national brokers.

How Protectionism Backfires

In this part of the report we have discussed two episodes – the beginning of the direct writers and the growth of inland marine – which illustrate the proposition that as technology leads to changes in insurance markets, the regulatory rules and business practices of the prior era can hold back the industry leaders as they try to adapt. Two other episodes discussed in the first part of the report – the risk management movement and the unbundling of insurance products – illustrate the same point. In all four of those instances, established regulation and established management combined to delay their own adaptation. The delay was long enough to let a less fettered competitor slip ahead.

The role of technology is each of those four little dramas was to open a new way to meet customer needs better and at lower cost. At the time it was no secret what was happening. But the established leaders were immobilized by some aspect of the world they had fashioned for themselves. For fire insurers, it was their price-fixing regime. For independent agents in personal property-casualty, it was their determination to hang onto functions. For life insurance companies and agents, it was their allegiance to one product and one commission scale. Without technology in the picture, the rigidities might not have hurt them so much. But technology offered a decisive competitive edge to whoever could apply it first, and the leaders could not.

That is the proposition that worries us about agent licensing and today's advances in information technology. The technology is sure to lead to changes all over insurance, especially in distribution. Fences put up to keep outsiders out can so easily work to keep insiders in. Both agents and regulators have a lot at stake, the agents because it is their livelihood and the regulators because the ultimate issue – regulation as a burden on interstate commerce – goes to the heart of their jurisdiction.

But we recognize we are arguing for a change in regulation without direct, unmistakable and irrefutable evidence that the trouble we predict will come to pass. That is the nature of all pleas to reform an institution before disaster has occurred or is irretrievably under way and, more generally, of efforts to get people to learn from the experience of others. That in turn is probably why timely reforms are so rare.

The four instances we have cited are, of course, not exactly the same as what technology will do to or for agents now. The protections that became prisons then were not exactly the same as state-by-state personal licensing and the resident agent laws. We will not have that kind of evidence until it is too late to do anything constructive and, probably, not until this episode is over.

But there is one episode that is directly in point and is ongoing at this very moment. It is not a stronger analogy, but it is certainly more immediate. And it involves agents and protections erected by agents. It is the commercial banks.

Insurance and banking are adjacent financial services with many features in common. At times in the past, insurance companies have had banking powers and banks have had insurance powers; insurance interests have owned banks and banking interests have owned insurance companies and agencies; and there are myriad ways for the two businesses to work together. But starting in the 1960s, the position of the

insurance industry, led by the property-casualty agents, has been that banks should be kept out of insurance.[35]

Several states now have laws forbidding affiliation between banks and insurers. Several federal statutes bear on the subject. This sounds simple but it certainly is not. The legislation has thus far been effective at keeping banks and bank holding companies out of insurance risk-bearing. It was also intended to keep them out of the agency side.

At least that was the idea. It gave the insurance industry and especially many agents a sense of insulation that may or may not have been well founded. More important, it let people on the insurance industry side of the fence postpone thinking about constructive cooperation and about what insurance companies and agents might do with some banking services to offer.

Recently the Supreme Court has come into the policy-making process. First it let banks into the business of selling annuities. Then it let banks into the agency business generally from bases in very small towns. It is not showing the deference to the McCarran-Ferguson Act in the regulatory area that it has shown in the anti-trust area. It can be expected to give short shrift to perceived interstate protectionism.

The outcome is utterly unpredictable by anyone. It is as non-linear and chaotic as billiards played with five balls on the table – state regulators, state legislators, federal courts, Congress and the Comptroller of the Currency. All that is certain is that the

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[35] The fear of banks was based on two aspects of the banks' market position, both very important at one time but much less so today. First was concern about tie-in sales, the lead or tying product being loans and the tied product being insurance. Good evidence for the fear was in the credit life and credit property insurance fields where they were not tightly regulated. But securitization of routine loans has put the bank lenders in a chronically oversupplied market, where creditworthy borrowing is a buyer's (i.e., borrower's) market and lenders no longer have coercive power. Second was the advantage in "trust, traffic and transactions" that banks supposedly had because of their reputation, branches and computing efficiency. Whatever leads the banks had in those areas were dissipated in the banking crises of the 1980s or, in the case of branches, were overtaken by technology.

banks will keep on trying; that opportunistic elements of insurance, banking and other industries will continue playing the situation; and that the insurance agents and insurance regulators have lost all control over what will happen.

Protectionism backfires not only in a loss of control but in at least three other ways. All can be seen in the bank-insurance situation and in the four past episodes recounted in this part and the first part of the report. Here are the three reasons why regulatory barriers to entry are a very treacherous ally for one competitor to enlist to keep another at bay.

One problem has to do with regulation. When a barrier comes down, the regulators have nothing in place. The dynamics and bargaining positions are very different, for the regulators have nothing to bargain with. No longer can they condition their grant of permission to enter the market upon the new entrant's accepting conditions or disabilities usually designed to level the playing field or even favor the incumbents.

A second danger is disruption of the competitive balance of supply and demand. When a barrier comes down, it comes down for everyone at once. New sellers rush in, quite likely impelled by unrealistic imaginings of how green the grass was when it was on the other side of the fence. With the fence suddenly down, their natural inclination is to leap in, with little regard to how their very presence will affect the market, usually by increasing supply and driving down prices. An ongoing illustration is in the European Union, where ancient national barriers are coming down, companies are hurrying in to each other's previously forbidden markets, and long-comfortable price structures are falling apart. A related problem with falling barriers is a rapid readjustment of comparative values. An example is the current turmoil in Southeast Asia, where fixed exchange rates could not withstand easier flows of capital into and out of currencies.

The third problem is technological advantage itself. When a barrier comes down, the new entrants will not have been allowed to invest in the activity earlier. So they will have no sunk costs to support and old equipment and arrangements to carry. They will be best able to start afresh with the most up-to-date technology. Where technology is what is changing the competitive situation in the first place, that can be a huge advantage.

A Flight of Speculation

Throughout this report, we have studiously avoided speculating about where technology might take us. Instead we have reasoned largely by analogy to developments that are already securely in the historical record or that are in progress today and hence verifiable by the reader's direct observation.

But sometimes a science fiction future is more vivid. So as to convey an idea of what might be coming, here is one scenario. It is already within technical reach. The open questions are whether people will want this sort of thing and whether it can be built into a sound business. Consider the Internet.

The Internet offers a way to send information and funds in two directions nearly instantly and over any distance. It offers anything a computer can deal with, which includes managing large amounts of data and displaying information attractively. It is indifferent to distances and to national (and, of course, state) boundaries. It is a textbook case of a technology that can cross boundaries of every kind, functional and jurisdictional, and it promises dramatic reductions in many aspects of the cost of dealing with information.

Internet commerce is growing daily. Consumers are already using the Internet to buy stocks and bonds, computers and software, books, CDs, airline tickets and

flowers, and they can even shop for cars and homes. New vendors are rushing in, inspired by the success of the early movers. Insurers and insurance agents are coming on too, but so far their sites on the Internet have been mainly for advertising and information. A little insurance is sold, but tentatively and at what look like standard prices.

Needed for a major breakthrough in insurance marketing via the Internet would be companies, new or existing, that would develop either commission-free rates or special rates for such distribution. Needed too would be a new model business, perhaps a managing agency that would sell nationwide or worldwide from a single location. It would probably get into all markets one way or another. Initial marketing could be by any of the mass or targeted media as well as by the Internet. Underwriting and rating could be by computer-executed algorithms, with electronic inquiry into data bases like state motor vehicle records.

The Internet may facilitate a dream long pursued by marketers: cross-selling. Websites for shopping for almost anything could be expanded to include insurance. Incremental costs would be extremely low, and some shopping groups might turn out to have demographic qualities that would make them good insurance prospects.[36]

We are describing not just a paperless but nearly a peopleless system. And a single digit expense ratio. We emphasize this is just speculation. It may never work. Nobody may want it. But Internet selling is far enough along in other markets that insurance regulators are already considering what their response should be.

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[36] A substantial test may be about to get underway, as the operator of a large shopping website, which also controls other customer lists with some 100 million names, is trying to buy a life and property-casualty insurance group with fifty licenses. See "It's! Not! Retail!", *Wired* (November 1997) and "Cendant Clears a Hurdle in Its Battle to Buy American Bankers Insurance", *The Wall Street Journal* (March 19, 1998).

Just thinking about it helps us appreciate how futile agent licensing laws would be to stop something of this sort, should it achieve a major cost advantage and then enjoy wide publicity and consumer demand. For regulation to try to stop it at that point would be as productive and popular, and ultimately as successful, as a regulator long ago trying to stop consumers and insurers from doing business by mail or telephone. This kind of speculation also makes one ask why independent agents and agency companies are not pursuing Internet marketing more aggressively, as it might be a big opening for them to compete against exclusive agency and direct response companies.

Besides noting the futility of obstruction, what can we say to regulators about the Internet? That it is a great opportunity. It has captured public attention. It dramatizes the potentialities of information technology. And it can inspire the commissioners to modernize an aspect of regulation they should want to modernize anyway but might otherwise not get around to – agent licensing.

Conclusions about Technology and Licensing

We have now seen enough of agent licensing to appreciate that it will tend to stand against the march of today's information technology in two respects.

First, information technology encourages breaking down the subject matter barriers that sub-divide the world of financial services. Agent licensing is based on one of those divisions. All regulation seems to expand from recognizing a distinction to enforcing it, and that is where the trouble comes when the competitive environment changes.

Second, technological advance shortens or eliminates distances in their time dimension and their cost dimension. State licensing of insurance agents is rooted in

state jurisdiction and in the local and personal character of insurance agencies when licensure began. In the resident agent or countersignature laws, licensure is even an exercise in explicit interstate protectionism.

Inherited, regulatory barriers of geography and function may hold if the attraction of technology is weak and the economic advantage small. They will not hold if the pull is strong and the saving large.

If the new advances in information technology can be used in insurance to lower costs and prices and to improve the ability of insurance to meet people's needs, then in the competitive market the users of the technology will prevail. Technology is doing so in other fields. It has a good 150-year track record of doing so in insurance. So it is a good bet.

But before prevailing, it would surely run up against the personal, local and protectionist aspects of state licensing of insurance agents. The conflict would cause harm to consumers and the industry. And to regulation as a separate institution. For licensing is a kind of regulation, an old, familiar, widespread and prominent kind. The vulnerabilities of licensing in the presence of technological change are just vivid examples of the weaknesses of all regulation – its reactive stance, its concern with borders and boundaries, its susceptibility to capture by regulated interests, its tendency to restrain competition and hence to restrain the evolution of the regulated business.

For insurance regulation, there is one more stake, made more real by the growing role of the courts in resolving issues once left to legislatures, to regulatory agencies and to corporate boardrooms. At stake is survival, at least in a recognizable and meaningful form. Among the issues sure to be examined by the courts in our national adjustment to the advances in information technology is the whole question of reasonable and unreasonable burdens on international and interstate commerce. State

insurance regulation, like any other regulation, is a burden on commerce. The question is whether it is a reasonable burden, to be tolerated for its benefits. State regulation will not be well served to turn its most anachronistic and parochial face to that scrutiny.

But all that harm to all those good institutions is avoidable. To avoid the collision between technology and licensing, the licensing laws should be reformed if they can be, that is, if collision can be avoided in ways consistent with sound, contemporary public goals.

Conclusion

The system of licensing insurance agents is a leftover. It is predicated on the American insurance business of the mid-nineteenth century. That business had several distinct characteristics. Agents were sole proprietors. Agents were local. Agents decided pricing. Indeed, agents performed most of the key functions in the insuring process.

The states developed a licensing system for agents that comported well with what agents were and did and what the states needed. Licensure was personal. Licensure was local. Licensure was based on where the agent had his office or where the customer lived. Licensure gave the state power over agents.

The purposes for which the states used licensure reflected the realities of the day. Licensure was the basis of state taxation of the insurance business. Licensure was a lever for restraining competition in rates. Licensure was used to restrain competition in commissions. Later on, licensure was used to make sure agents knew their trade, and licensure was used to protect local interests.

It is all understandable, but most of it is anachronistic. It no longer reflects what agents do or the business setting in which they do it.

Most times that would not matter. Regulated business and regulation itself have a rather high tolerance for anachronism. Regulated business normally has the ability to pass on unneeded costs, and its customers have no ability to resist. That has been changing in insurance for the past fifty years, and the pace of change is picking up. The reason is recent advances in information technology. They are likely to bring to insurance what they have brought to other businesses – lower costs and a breakdown of borders of function and geography. The cost of anachronism is sure to go up.

Regulation generally cannot for long stand against very powerful economic forces that bring costs down and increase consumer choice. Nor should regulation want to do so where its public purposes can be achieved without getting in the way. That appears to be possible with agent licensing today, to take it off the collision path with information technology.

A lot has changed in insurance and insurance regulation in the century and a half since the agent licensing rules were laid down. But those rules have not changed much at all. What is needed now, so as to avoid a collision between technology and license regulation, is to bring agent licensing up to date. That is not a call for revolution or repeal. It is a call for simplification, particularly in what business people around the country have to do to comply. Simplification here, as elsewhere, needs to be based on a deeper understanding of the elements of the problem than we normally need. This report has tried to provide some of the information needed.

People who want to avoid a collision between technology and licensing should move pretty quickly. In recent years technological change, and the economic change to take advantage of it, have proceeded rapidly. Regulation of all kinds is conservative and reactive, and change there takes its own time. Usually that is harmless. But there are exceptions. The exceptions are when the regulated industry has to change quickly to keep up with its customers and its competitors. The exceptions are when the regulatory system has to move quickly to get out of the way. Information technology and the licensing of insurance agents are coming together to create one of the exceptions now.

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Authorship of the Report

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