5

Regulation and Evaluation of Insurers

Learning Objectives

An understanding of the material in this chapter should enable you to

5-1. Explain the general purpose of insurance regulation.

5-2. Describe the methods of insurance regulation.

5-3. Describe the kinds of insurance regulation by the states, and explain the issue of state versus federal regulation.

5-4. Discuss the criteria for selecting an insurer and agent or broker.

Financial planners clearly need to understand insurance regulation in order to understand the regulatory environment in which they work. Insurance is a highly regulated business, and insurance regulation is subject to frequent change. This chapter explains why and how the business of insurance is regulated. It also describes factors a client should consider in evaluating and selecting an insurance company, as well as an agent or broker.

The value of insurance contracts depends on the insurer's ability to fulfill these policies' promises to the public, sometimes many years after the policies are issued. Ability to carry out contract provisions depends on many factors, including the efficient operation of the insurer, satisfactory underwriting, proper premium rates, and wise investment of adequate reserves.

The general purpose of insurance regulation is to protect the public against insurer insolvency or unfair treatment by insurers. From the state's viewpoint, regulation is also important because state taxes on insurance premiums are a substantial source of revenue.

As mentioned earlier, the insurance business is generally considered to be "affected with a public interest." This characteristic explains why many types of government supervision of insurance are deemed necessary. Uncontrolled competition in insurance could impose a hardship on insurance buyers and insurance claimants or beneficiaries who do not understand insurance contracts.

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SOURCES OF INSURANCE REGULATION

State governments undoubtedly play the most important role in regulating insurance. Before we consider this and other phases of government insurance regulation, however, we will summarize insurance self-regulation.

Self-Regulation of Insurance

After explaining the general concept of self-regulation, we will examine some of the ways this concept is currently applied within the insurance business. The concept of self-regulation in general is clearly described in the following excerpt from remarks made in 1998 by Robert Pitofsky, chairman of the Federal Trade Commission:[21]

> The public and private benefits of industry self-regulation are many. First, self-regulatory groups may establish product standards that often assure safety. The private standards "industry," with groups such as the American National Standards Institute (ANSI) and the American Society of Mechanical Engineers (ASME), promulgates tens of thousands of voluntary standards to promote safety or quality. In turn these standards may facilitate the emergence of markets by establishing minimum levels of product quality, and improving consumers' understanding and trust of new products.
>
> Standard setting also can lower the cost of production. For example, a standard can be established to assist manufacturers in producing interconnecting or interchangeable parts. Especially in high-tech industries, standards assure a manufacturer that if its product conforms, the product will interconnect with complementary or rival products of similar specifications.
>
> Industry self-regulation also helps consumers evaluate products and services by providing information about the qualities and characteristics of the seller's products. As then-Circuit Judge Breyer explained, the promulgation of standards "provide[s] information to makers and to buyers less expensively and more effectively than without the standard."[22] Testing organizations that grade products, such as Underwriters' Laboratories or Consumer Reports, can provide these benefits.
>
> An industry group may engage in self-regulation to enhance its reputation for fair and honest service by establishing ethical standards and disciplining those who do not abide by the standards. Professional

21. Self-Regulation and Antitrust, prepared remarks of Robert Pitofsky, Chairman of the Federal Trade Commission, DC Bar Association Symposium, February 18, 1998, Washington, DC (www.ftc.gov/speeches/pitofsky/self4.htm, accessed 9/26/06).
22. See *Clamp-All Corp. v. Cast Iron Soil Pipe Institute*, 851 F.2d 478, 487 (1st Cir. 1988), *cert. denied,* 488 U.S. 1007 (1989).

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associations, for example, often exclude unqualified applicants to assure the public that practitioners possess a minimum level of competence and to protect the associations' reputations as well. Self-regulation often may deter conduct that would be universally considered undesirable, but that the civil or criminal law does not prohibit. For example, cheating in sporting contests may not violate the law because the improper conduct is not considered sufficiently serious or because no injured party is likely to appear to bring suit. As a result, industry self-regulation may provide the only meaningful deterrent to would-be cross checkers and bean ball artists.

From a public policy perspective, self-regulation can offer several advantages over government regulation or legislation. It often is more prompt, flexible, and effective than government regulation. Self-regulation can bring the accumulated judgment and experience of an industry to bear on issues that are sometimes difficult for the government to define with bright line rules. Finally, government resources are limited and unlikely to grow in the future. Thus, many government agencies, like the FTC, have sought to leverage their limited resources by promoting and encouraging self-regulation.

Of course, self-regulation can be anticompetitive. Competitors may use the self-regulatory process to disadvantage new rivals or new forms of competition. When that happens, enforcement must be forceful and firm. As the Supreme Court has observed in connection with standard setting:

"There is no doubt that the members of [private standard-setting] associations often have economic incentives to restrain competition and that the product standards set by such associations have a serious potential for anticompetitive harm. Agreement on a product standard is, after all, implicitly an agreement not to manufacture, distribute, or purchase certain types of products. Accordingly, private standard-setting associations have traditionally been objects of antitrust scrutiny."[23]

And of course, government regulation has advantages of its own, such as the increased chance that a point of view other than the industry's will be considered in developing and applying the standards.

Cooperation by insurers to regulate themselves is permitted by law and is practiced extensively. Many insurers and trade association groups exercise considerable control or provide advice with regard to each of the major functions of insurance. For example, Insurance Services Office (ISO) compiles loss data and drafts and files forms for many property and liability types of insurance on behalf of individual insurers for approval by the state insurance departments, saving duplication of effort and reducing costs. In claims administration, independent adjusting firms handle some losses involving several insurers, so that several insurers involved in the same losses

23. *Allied Tube Conduit Corp. v. Indian Head, Inc.*, 486 U.S. 492, 500-01 (1988).

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do not need to provide separate loss investigation and payment services. Many insurers cooperate with one another to coordinate loss prevention. Examples include the Insurance Institute for Highway Safety and the National Fire Protection Association. The MIB Group, Inc. gathers information needed in life insurance and disability income insurance underwriting. Rules that apply to members of numerous organizations of insurance agents, brokers, and companies regulate marketing activities. Insurers' joint efforts with LIMRA International and the Society of Insurance Research (SIR) enhance research. The American Council of Life Insurers (ACLI), the Insurance Information Institute, and the Risk and Insurance Management Society (RIMS) promote better public relations and legislation. To improve insurance education and set standards for professional courses and designations, the following organizations are important: the American Academy of Actuaries, The American College (and the related LUTC), the American Institute for CPCU (and the related Insurance Institute of America), and the Life Office Management Association (LOMA). Professors of insurance and other industry personnel exchange much valuable information through conferences and publications of the American Risk and Insurance Association (ARIA). The Society of Insurance Trainers and Educators (SITE), an organization dedicated to providing performance improvement opportunities to Society members through programs, networking, and services, is committed to sharing knowledge and resources through collaboration within the insurance industry. Many insurers and these types of organizations supply representatives directly to industry committees that work in conjunction with government regulatory bodies to draft legislation, coordinate programs, and improve both self-regulation and public regulation of insurance. For example, the National Association of Insurance and Financial Advisors (NAIFA) has encouraged much legislation for implementation in state legislative bodies.

Self-regulation works extremely well in some aspects of insurance, while in others it is disappointingly ineffective. Difficult areas for self-regulation include competitive practices that involve such factors as production costs, commissions, advertising, selling practices, and rates.

Ethical Standards

In the area of individual life insurance, annuities, and long-term care insurance sales, the Insurance Marketing Standards Association (IMSA) has been active for over a decade in setting ethical standards. IMSA is a voluntary not-for-profit organization, and its mission is to strengthen trust and confidence in the life insurance industry. IMSA member companies are required to demonstrate commitment to high ethical marketplace standards. IMSA-qualified companies commit to maintaining high ethical standards and to being fair, honest, and open in the way they advertise, sell, and service their products.

No direct counterpart to IMSA exists in the property-liability area. However, organizations such as the CPCU Society have been especially

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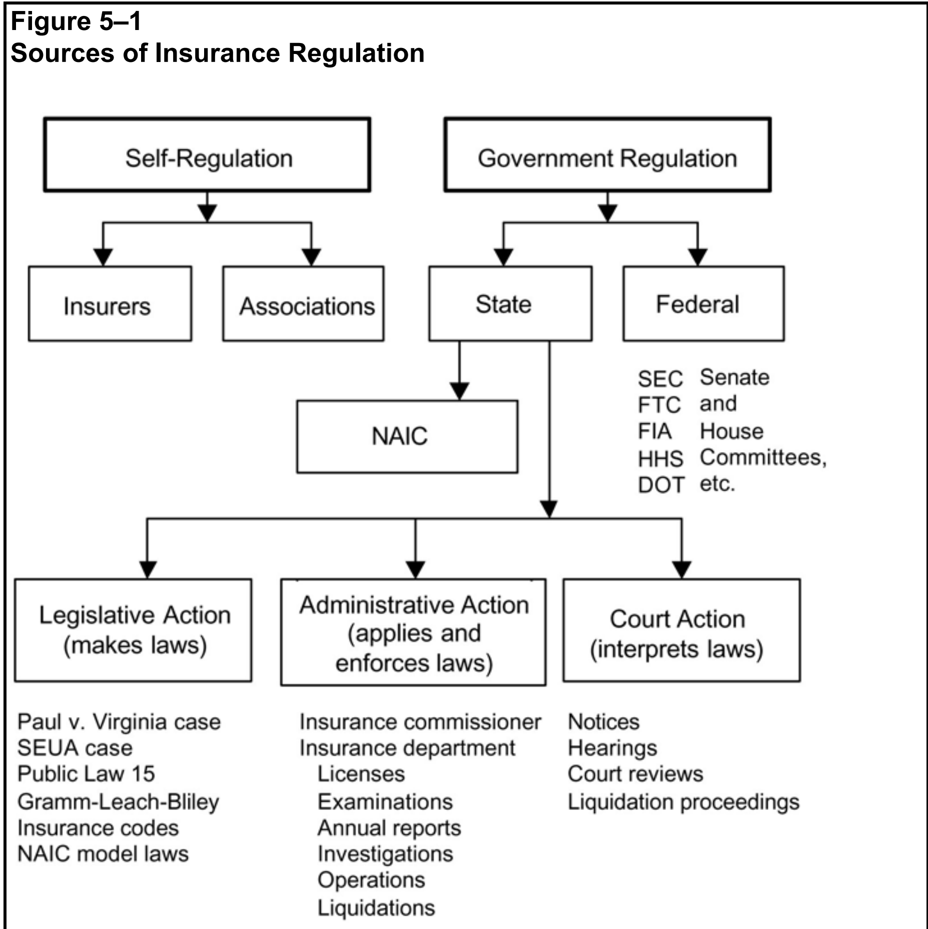
visible in promoting ethical behavior among Society members and within the insurance industry as a whole. Many other insurance industry associations, as well as individual companies, have also developed codes of ethics to which their members must adhere.

As a review of this section on self-regulation and as an introduction to the next section on government regulation, see Figure 5-1, which summarizes the methods of insurance regulation.

Figure 5–1
Sources of Insurance Regulation



Government Regulation of Insurance

Three basic methods of government insurance regulation are available: (1) legislative action, (2) administrative action, and (3) court action. These correspond to the three main branches of the government. Legislation is the foundation of insurance regulation because it creates the insurance laws. The insurance laws of each state are often combined in what is known as an

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insurance code.[24] The application and enforcement of insurance laws are left in the hands of the insurance commissioner, the administrative official in each state. Court action provides detailed interpretations of troublesome parts of the law.

Legislative Action

State regulation of the insurance business was well established by the late 1800s and continues today as the predominant form of regulation. The practice is based on a series of court decisions, and it has been continued despite some contention that insurance might better be regulated by the federal government. In the classic 1868 case *Paul v. Virginia,* the Supreme Court decided that insurance "is not a transaction of commerce" and thus can be neither interstate commerce nor subject to federal regulation.[25] Until 1944, a period of about 75 years, the Supreme Court upheld the *Paul v. Virginia* decision.

In 1941, the Department of Justice heard complaints that certain insurance company practices violated the Sherman Antitrust Act. In 1944, the U.S. Supreme Court handed down a momentous four-to-three decision before one of its largest audiences in history. This case, *U.S. v. South-Eastern Underwriters Association (SEUA) et al.,* [26] now known to the legal profession and to the insurance business as the *SEUA* case, held that insurance is commerce. Thus, because of its interstate nature, it would be subject to federal regulation.

However, because of delegation of authority by Congress, the regulation of the business of insurance remains primarily a state function. The specific delegation to the states of the power to regulate insurance occurred with the passage of Public Law 15, also known as the McCarran-Ferguson Act or simply the McCarran Act, in 1945.[27] Congress made the Sherman Act, the Clayton Act, and the Federal Trade Commission Act applicable to the business of insurance after January 1, 1948, "to the extent that such business is not regulated by state law." In other words, the jurisdiction for regulating interstate insurance was left with the individual states as it had been for many years, but the important proviso was added permitting the federal government to take over insurance regulation if state regulation should become inadequate.

The enactment of the Financial Services Modernization Act, also referred to as the Gramm-Leach-Bliley Act, again addressed the regulation issue as a result of a growing number of affiliations between banks and insurance. Traditionally, the federal government and, in some cases, the states regulated banking activities, while only the states regulated insurance. The act indicated

24. The insurance code for an individual state can exceed several hundred pages.
25. Today it is difficult to rationalize such a decision, but in 1868 the now famous decision stated, "Issuing a policy of insurance is not a transaction of commerce. They are not commodities to be shipped or forwarded from one state to another and then put up for sale. . . . Such contracts are not interstate transactions, though the parties may be domiciled in different states. They are, then, local transactions and are governed by local law." From *Paul v. Virginia,* 231 U.S. 495.
26. 64 United States 1162.
27. C 20, 79th Cong., 1st sess.

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that each segment of the financial services business is to be regulated separately and that states continue to have primary regulatory authority for all insurance activities.

National Conference of Insurance Legislators (NCOIL)

Many state legislators whose primary focus is insurance legislation and regulation belong to an organization known as the *National Conference of Insurance Legislators*. The purpose of the National Conference of Insurance Legislators (NCOIL) is to help legislators make informed decisions on insurance issues that affect their constituents and to declare opposition to federal encroachment of state authority to oversee the business of insurance, as authorized under the McCarran-Ferguson Act of 1945. Toward that end, NCOIL works to:

- educate state legislators on current and perennial insurance issues
- help state legislators from different states interface effectively with each other
- improve the quality of insurance regulation
- assert the prerogative of legislators in making state policy regarding insurance
- speak out on Congressional initiatives that attempt to encroach upon state primacy in overseeing insurance

Many legislators active in NCOIL chair or are members of the committees responsible for insurance in their respective state houses across the country.

Today, most insurance regulation remains with the states. However, federal legislators, consumer advocates, and various insurance industry associations frequently question whether all or some of these regulatory activities should instead take place at the federal level, reducing the challenges and inefficiencies both U.S. and alien insurers currently face in meeting the requirements of more than 50 jurisdictions. Issues recently discussed at the federal level include such diverse topics as the role of banks in insurance, terrorism coverage, and underwriters' use of credit scoring.

Although most insurance regulation takes place at the state level, the role of federal insurance regulation has been gradually expanding, as noted later in this chapter.

Landmark Events in the History of Insurance Regulation

- U.S. Supreme Court decision in the case of *Paul v. Virginia,* 1868
- U.S. Supreme Court decision in the case of *U.S. v. South-Eastern Underwriters Association,* 1944
- Public Law 15 (McCarran-Ferguson Act), 1945
- Financial Services Modernization Act's reaffirmation of states' primary role in insurance regulation, 1999

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Administrative Action

The insurance commissioner[28] of each state has broad powers. The commissioner's authority extends to licensing insurers and agents; requiring annual reports from the insurers; approving forms and rates in some, but not all, lines of insurance; and investigating complaints of many kinds. According to data released by the National Association of Insurance Commissioners (NAIC), the top five reasons consumers filed formal complaints against their insurance companies in one recent year were delays, denials of claims, unsatisfactory settlement offers, policy cancellations, and premium/insurance rating issues.[29]

In most states, the insurance commissioner is appointed by the governor and is a member of the governor's cabinet. The rationale behind this method of choosing the head insurance regulatory official is that the governor is ultimately responsible for the business success of his or her term of office and therefore should be able to appoint a person to carry out this responsibility. In about 10 states, insurance commissioners are elected by voters in a general election. Recent history has not demonstrated that either voters or governors have done a better job of selecting commissioners of high caliber and integrity. Both methods of selecting and retaining insurance commissioners clearly involve a political process.

The insurance department within which insurance commissioners carry out their duties may vary from a few persons in some states to several hundred employees in a state such as New York. Many departments have existed for a century or more. Some states have relied on New York as their guide for insurance legislation and administrative action. Some New York laws apply to all insurers licensed there, wherever they do business, a provision called extraterritoriality. This provision has played an important role in creating a degree of uniformity in practice among many states.

The insurance commissioner's major powers involve licensing, examination, and investigation. In addition to following the required incorporation procedure for domestic organizations, each insurer that wishes to do business in the state must be licensed for the lines of business it plans to write. The commissioner has broad interpretive powers to decide whether an insurer is qualified, financially and otherwise, to operate in the state. Licenses are usually renewable on an annual basis. The insurance commissioner has considerable power to refuse to issue a renewal license, as well as the power of suspension or revocation. Tests are also administered for licensing insurance agents or brokers.

On-site examination of insurers once they have been licensed is also an important responsibility of the commissioner. Insurers' continued solvency is the major objective of detailed examinations that are conducted

28. Most of the states use this title of "commissioner of insurance," eight use "director of insurance," and three use "superintendent of insurance."
29. NAIC Cites Top Insurance Complaints for 2007," NAIC News Release, posted January 31, 2008; http://www.namic.org/topnews/080131st1.asp?utm_source=weekly& utm_medium=email, accessed 2/7/08

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according to law, at intervals usually from 3 to 5 years. Checking assets, liabilities, and reserves is part of this procedure, as is reviewing the insurer's underwriting, investment, and claims practices. A regional zone system is used in cooperation with the National Association of Insurance Commissioners (NAIC) to avoid unnecessary redundant examination of multistate insurers by many states. In this way, the examination of insurers licensed in many states is standardized and simplified, and all states in which the insurer does business accept the results of the regular zone examination. In the intervening years between complete examinations of insurers, every state requires the filing of an Annual Statement with the insurance commissioner. This filing reports current financial conditions and changes that have occurred during the year. A standard NAIC form is used that, for most details, provides uniformity of the information the statement requests. These Annual Statements are available to the public in the state insurance department offices.

National Association of Insurance Commissioners (NAIC)

model law

model regulation

We previously mentioned NCOIL, an association of state legislators. Insurance regulators also have an association. The *National Association of Insurance Commissioners (NAIC)* is a voluntary nonprofit association of state insurance administrators. The NAIC itself has no regulatory authority. It is important, however, not only for the zone examination procedures but also for its influence through the commissioners on uniformity of insurance laws in the various states. The NAIC assists state insurance departments by developing model laws and regulations. A *model law* is a draft bill—the suggested wording of a new law—for consideration by state legislators. Any state may choose to adopt the model bill or adopt it with modifications. A *model regulation* is a draft regulation that may be implemented by a state insurance department if the model law is passed. The insurance laws and regulations of many states incorporate at least the primary concepts of NAIC model laws, resulting in some degree of uniformity among the states.

The NAIC has been criticized for its inability to bring about greater uniformity in state insurance legislation. A program under which the NAIC accredits state insurance regulatory bodies, based largely on the extent to which the state has adopted certain of the NAIC's model laws and regulations, has been developed to counter some of this criticism. The NAIC has recommended many model laws and regulations for such areas as holding companies, variable contracts, guaranty funds, life insurance replacement, and unfair advertising. In addition, the NAIC has been instrumental in developing risk-based capital requirements. These requirements call for differing minimum amounts of capital that insurers must maintain, based on the riskiness of their insurance and investment operations. Other NAIC model laws or regulations deal with unfair claims practices, privacy protection, unfair sex discrimination, and long-term care policies, among numerous other topics. Major research projects have covered such topics as auto insurance, premium taxation, competitive rating, credit life and health insurance, and mass marketing. Statistical reporting systems both for testing company solidity and for measuring profitability have been operational for several years.

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The insurance commissioners' investigative powers help determine whether insurers and their representatives meet statutory requirements. Open access to insurers' records and books and hearings on such matters as rate violations and unfair trade practices are examples of this authority. As a result of such procedures, which are often informal, the commissioner may issue administrative rulings or advisory opinions with regard to the business conduct of insurers or their agents. In extreme cases, the commissioner can declare an insurer insolvent and order its liquidation. All these investigative powers have as their major goal the protection of insurance policyowners and claimants.

Financial planners must realize that insurance regulation does not serve as a guarantee against any and all possible insolvencies and abuses, but the commissioner's insurance regulatory powers do serve as an important means of reducing such problems.

Judicial Action

The broad authority of insurance commissioners is subject to review and interpretation by the courts. To determine whether the commissioner's duties conform with state statutes, the courts may review the notice and hearing procedures that commissioners use to arrive at official rulings. Examples are actions to compel the commissioner to issue a license to an insurer or to prevent its cancellation, and court review of decisions to permit or refuse rate increases. The courts may be used in private actions or by the attorney general of the state against an insurance commissioner, and the commissioner may also, for example, petition the courts to enforce compliance with laws or rulings. Courts also resolve disputes between insurers and policyowners or insurance claimants.

WHAT IS REGULATED BY THE STATES

The insurance codes, as well as the general business laws, vary among the 50 states. This section of the chapter summarizes the regulation typically found in the more important insurance jurisdictions, such as New York state.

Insurance regulation by each state is largely aimed at the insurers that conduct an insurance business within the state's jurisdiction. Some regulation is also provided for agents, brokers, and other persons who are part of the marketing of insurance contracts and provide certain other services to insurance policyowners. The regulation of insurers falls into the following categories:

- formation and licensing of insurers
- supervision of insurer operations
- rehabilitation and liquidation of insurers

Truly, the birth, life, and death of an insurance company are in the hands of the state regulators.

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Formation and Licensing of Insurers

Insurance companies are required to meet specific standards that are often higher than those set for general business organizations. The rationale for high standards is discussed earlier in this chapter. Standards that ensure the solvency, competence, and integrity of the insuring organization are necessary. The first step is incorporation,[30] an introductory process in which the state recognizes and approves the existence of a new legal identity.

The next step, licensing, is a check on the insurer's financial condition to ascertain that it has the required initial capital and surplus for the kinds of insurance permitted in the license. Domestic, foreign, and alien insurers that wish to become "admitted" insurers in the state must meet the statutory requirements for licensing. (Nonadmitted insurers are discussed briefly in chapter 3.) The laws usually specify standards for foreign and alien insurers at least as high as those for domestic insurers. Standards vary by legal type of insurer, with requirements for mutual insurers somewhat different from those for stock insurers. These standards also vary widely in the different states.

The licensing procedure is not dependent on financial requirements alone. Many states give the insurance commissioner leeway to apply considerable judgment in acting, or refusing to act, on a license application. The objective of licensing is to provide a preliminary method to lessen the chance of insurer insolvency, particularly during the difficult formative years. A license may be denied for many other reasons, including the bad faith or reputation of the proposed incorporators or management of an insurer. General managerial ability is undoubtedly as important as capital and surplus requirements for an insurer to achieve sustained financial stability. For that reason, the insurer's license is no more a guarantee against failure than an auto driver's license is a guarantee against an accident.

Insurer Operations

Insurance regulation continues after the formation and licensing of an insurer. Continual regulation is needed because most insurer obligations extend years into the future, and the state should provide supervision so that the contractual promises are fulfilled. The ways in which insurer operations are supervised are strikingly different among the states and among the various kinds of insurance. Most states provide some regulation contracts and forms, rates, reserves, asset and surplus values, investments, agents' licensing and trade practices, claims practices, and taxation.

30. Reciprocal exchanges, Lloyd's associations, fraternals, and some health insurance associations do not legally become incorporated by this process. They do, however, file similar statements of their present status and proposed activities as stated in their charters and bylaws.

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Contracts and Forms

Because insurance policies are complex legal documents that consumers often do not fully understand, they could be used to mislead or unfairly treat policyowners. Consequently, in many lines of insurance, policy forms must be approved by, or at least filed with, the insurance commissioner. The task of gaining approval is simplified if an insurer uses a standard policy form developed by an insurance advisory organization, such as ISO or the American Association of Insurance Services (AAIS). Independent insurers may have individualized contracts that vary significantly.

Life and health insurance contracts are not standard contracts in the sense that similar forms or benefits are required. Most states do, however, impose some uniformity by requiring standard provisions in life and health contracts pertaining to such items as loan and surrender values and the grace period.

Many insurance forms are subjected to little or no regulatory review. For example, the contracts that cover property in transit are not at all uniform, and policyowners should review their benefits, conditions, and exclusions carefully.

Rates

The regulation of insurance pricing varies by line of business. In some lines of insurance, such as aviation insurance, practically no state regulation exists. In life insurance, regulation involves maintaining minimum reserves, rather than setting prices. Many kinds of insurance are subject to some direct rate regulation.

Insurance rating laws usually require that rates be

- *adequate*. Rates are considered adequate rates when, along with investment income, they are expected to produce sufficient revenue to pay all losses and expenses of doing business, along with a reasonable profit.
- *not excessive*. Rates are considered nonexcessive rates if they do not generate an unreasonably high profit for the insurer. This, however, does not guarantee that rates will be affordable to consumers.
- *not unfairly discriminatory*. Rates are considered not unfairly discriminatory rates if they reflect the expected loss costs and expenses of the homogeneous group of insureds to whom they apply.

Discrimination and Insurance. It is important to distinguish between discrimination and unfair discrimination.

For example, in the United States, age discrimination is considered inappropriate for many business purposes. However, age discrimination is commonly practiced in insurance rates, especially with regard to life insurance. Age discrimination in life insurance rates is not *unfair* discrimination, because it reflects the differing mortality rates of people of different ages and enables insurers to charge equitable premiums.

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Any rebate of the insurance premium to an insured, other than dividends to a class of policyowners, is considered discriminatory in most states. A rebate is usually contrary to the law, whether it is made in the form of a direct payment or a credit against the premium or by means of any subterfuge. The statutes do not, however, prohibit the payment by one broker or agent of a part of his or her commission or other compensation to other licensed agents or brokers.

Proposed rates for property and liability insurance are often based on loss data accumulated by advisory organizations, formerly called rating bureaus. Subscribing insurers add loss data to margins for covering expenses, contingency reserves, and desired profits. Some large insurers do not subscribe to these organizations' services and instead base rates on their own independent loss and expense data. Individual insurer rate making has increased in recent decades and has become an important factor in auto insurance and homeowners contracts.

Many of the states passed rating laws some 50 years ago, following a model bill the NAIC developed. In these states, the laws provide specifically that there is no intent to prohibit or discourage reasonable price competition, and they do not prohibit or discourage price uniformity. The laws permit, but do not require, concerted rate making. The state insurance department passes on the reasonableness of the rules and regulations of rating advisory organizations that furnish insurers with loss statistics and other material for rate making. An advisory organization may not exclude or withhold its facilities from any insurers, each of which has the statutory right to become a subscriber by paying reasonable fees.

Types of Rating Laws. Several different types of rating laws are used in different states and lines of insurance. The most common types are (1) prior approval laws, (2) file-and-use laws, (3) open competition laws, (4) use-and-file laws, and (5) flex-rating laws.

prior approval law

A *prior approval law* requires that the proposed rates be filed with the insurance commissioner. The rates may not be used by the insurer unless and until the commissioner approves them. With increased competition, potentially lower rates, and deregulation of insurance, prior approval laws have come under heavy fire. Although some states have adopted other types, regulation through prior approval laws remains predominant.

file-and-use law

Several states employ a *file-and-use law,* which permits the immediate use of filed rates without the insurance commissioner's affirmative approval. The commissioner, however, may disapprove the rates within a certain time period,

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such as 30 or 60 days. Some states use this method for one type of insurance while retaining the prior approval rule for other kinds of insurance.

use-and-file law

Numerous states have a *use-and-file law*. Rates must be filed with the insurance commissioner within a specified time after they are first used. The rates may be disapproved if not in compliance with the law.

flex-rating law

A few states have enacted *flex-rating laws* for some lines of insurance. Under these laws, no regulatory approval is needed if a proposed new rate represents a change of less than 5 or 10 percent or some other stated percentage of the existing rate. Other rate changes require prior approval.

open competition

From time to time for some lines, some states have also adopted *open competition,* which was pioneered in California. Open competition, which relies on competition to set rates, actually represents the absence of government regulation. A broader movement toward open rate competition for commercial insurance exists.

Instead of directly regulating insurance prices, some state laws supervise the cost of life insurance by limiting the portion of the premium that can be used for expenses other than claims. The New York law applicable to life insurance is most influential in this regard because, under the extraterritoriality provision, all insurers that do business in that state must conform to its regulations for all insurance contracts, regardless of where they are written.

Types of State Laws Affecting Insurance Rates

- Prior approval laws
- File-and-use laws
- Use-and-file laws
- Flex-rating laws
- Open competition
- Expense limitation laws

Reserves

The states require insurers to maintain, as a liability on their balance sheets, a minimum reserve considered adequate to meet policy obligations as they mature.

legal reserve

Life Insurance. In life insurance, the *legal reserve* is an amount that, augmented by premium payments under outstanding contracts and interest earnings, is sufficient to enable the life insurer to meet its expected policy obligations. These include death benefits and nonforfeiture benefits, such as policy loans and surrender values. Insurers need to charge premiums sufficient to pay expenses and meet the legal reserve requirement. Requiring these minimum reserves therefore indirectly regulates life insurance rates, or at least reduces the likelihood of inadequate rates.

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unearned premium reserve

Property and Liability Insurance. In property and liability insurance, the *unearned premium reserve* must always be adequate to pay a return premium to all policyowners if their policies are canceled prior to expiration. The unearned premium reflects the proportion of the written premium that the insurer has not earned by providing protection for the full policy period. The purpose of this reserve is to meet all liabilities under the contract and to pay expenses in the future. At the same time, it accounts for income the insurer has received but not yet fully earned.

Example: Assume that an insurer issues a 1-year homeowners policy on October 31 of a particular year. On December 31 of that year, the insurer has an unearned premium equal to five-sixths of the annual premium for the policy. This and the unearned premiums for other unexpired policies make up the unearned premium reserve shown as a liability on the insurer's balance sheet.

loss reserve

A second type of reserve required of property and liability insurers is the *loss reserve*. The loss reserve reflects the insurer's liability for losses that have already occurred but have not yet been paid or otherwise settled. Because many claims do not result in immediate payment of all incurred losses, the insurer must set up a reserve to ensure their payment. For example, a workers' compensation claim may be made against the insurer today. However, payments to the claimant are made gradually over a long future period of disability. In auto liability cases, several years may elapse after a loss before a court decides who is liable and for how much. In these cases, an estimate of the reserve that will be needed to pay the insurer's obligation is made and carried on its books as a loss reserve. In this way, losses and loss expenses for claims that are incurred but not yet paid are provided for by the insurer under the loss-reserve laws of the states.

Simply put, even if the money has already been collected, property-liability insurers may not count premiums as earned until the period for which they purchase coverage is completed. Collected premiums are an asset, but any premiums that have not been earned are an offsetting liability—the unearned premium reserve. Insurers are also required to count as a liability—the loss reserve—the full estimated value of all losses as soon as they happen, even if the actual claims payment occurs much later.

Assets and Surplus Values

The value of assets that appear on insurers' balance sheets must be correct and conservative in order for liabilities, other reserves, and residual surplus items to be meaningful. Securities insurers hold are valued according to practices adopted by a committee of the NAIC. Stocks are usually given

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year-end market values, while most bonds are carried at amortized values. The valuations are only advisory to the states, but the result is a good example of voluntary and state regulation working together. For some insurers, such as mutual insurers, both surplus accumulation and distribution are subject to regulation aimed at providing equitable treatment for all policyowners.

nonadmitted asset

Insurance companies are required to file detailed financial information with insurance regulators in a form known as an Annual Statement. Insurance companies are required to characterize some assets on their Annual Statements as nonadmitted assets. *Nonadmitted assets* are thought to be of marginal quality or of little liquidity for policyowners if their insurers should get into financial difficulty. Examples of nonadmitted assets are most office furniture and supplies, as well as premiums that are 90 days or more past due.

Investments

To protect insurer solvency, most states have laws that govern the types of securities that may be purchased for investment. The strictest regulations apply to life insurers because they retain many billions of dollars of assets for many years for their policyowners.

Life insurers' investment portfolios are subject to rigorous supervision. Each Annual Statement lists every investment with detailed information about its date of acquisition, costs, values, and earnings. As noted in chapter 4, bonds and common stocks are the prime investments in life insurers' portfolios, constituting a large majority of total assets. Most states grant limited permission for certain investments. Stocks may be limited, for example, to a stated percentage of assets or to 100 percent of surplus. Real estate holdings, especially commercial properties and housing projects, are also limited to a maximum in various states. The legality of all the insurer's holdings is checked carefully in periodic audits of the insurer's portfolio.

Property and liability insurers' investment portfolios are also supervised, although the laws are more lenient and vary greatly among the states. The laws of each state specify the investment restrictions. The general practice aims at requiring the safest types of investments for all assets held as reserves, both for unearned premiums and losses, and for other liabilities. Cash, high-grade bonds, and perhaps preferred stocks of proven quality may be permitted for such assets. The remainder of assets (representing capital and surplus) may be invested in a wider range of securities, including common stocks that meet certain standards. Limitations on real estate holdings, the size of single investments in relation to total assets or surplus, and investments in foreign companies, as well as many other restrictions, are also common.

Producer Licensing

Laws in all states require insurance agents and brokers to be licensed. The insurance departments usually administer these laws. The objective is insurer representation that is competent and trustworthy. All states require a

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comprehensive written examination before agent licensing. The examinations are often divided into separate tests for different lines of insurance. Some adjusters and consultants also must be licensed in a few states. All states now require continuing education as a condition for license renewal.

Financial planners per se are not regulated by federal or state governments. However, the activities and conduct of financial planners are subject to government regulation, because most of the individual components of the financial planning process are regulated. Thus, federal or state securities regulators oversee financial planners in their capacity as investment advisors; federal or state securities agencies also regulate those financial planners who sell securities. Additionally, many engaged in financial planning are subject to state regulation of insurance brokers and agents, accountants, or attorneys.

Financial planning often includes an analysis of a client's insurance needs. Financial planners, therefore, may find themselves subject to government regulation of insurance, which primarily means state regulation. In some states, financial planners are even subject to regulation if they recommend a generic insurance product or a specific amount of insurance without referring the client to an insurance agent or acting as insurance agents themselves. Some states, however, make insurance licensing easier for accredited financial planners by exempting individuals holding the CFP or other designations from insurance testing requirements.[31]

Unfair Trade Practices

unfair trade practices

As mentioned earlier, the McCarran-Ferguson Act left insurance regulation to the states with the stipulation that the federal government could take over if state regulation should become inadequate. To help maintain adequate state regulation, the NAIC developed the model Unfair Trade Practices Act, and almost all U.S. jurisdictions have adopted *unfair trade practices* acts. The acts prohibit unfair trade practices in insurance, including the following:

rebating

twisting

misappropriation

commingling of funds

- *rebating:* Rebating is the return of any part of the premium, except in the form of dividends, to the policyowner by the insurer or agent as a price-cutting sales inducement[32]
- *twisting:* Twisting is a special form of misrepresentation in which an agent may induce the policyowner to cancel disadvantageously the contract of another insurer in order to take out a new contract
- *misappropriation:* Misappropriation is an agent's unlawful keeping of funds belonging to others
- *commingling of funds,* which occurs when an agent mixes the insured's or the insurer's funds with the agent's personal funds; commingling of funds is prevented in some states by requiring a

31. Taylor, Don A., and Worsham, C. Bruce (eds.), *Financial Planning Process and Environment*, The American College Press, Bryn Mawr, PA, 2005, page 9–3. The information cited in Taylor et al. is taken from Macey, John R., Regulation of Financial Planners, White Paper Prepared for the Financial Planning Association, 2002, pp. 13, 55–56.
32. Rebating is allowed in two states, but only under very limited circumstances.

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separate bank account for the agent's premium funds held in trust for the insurer

- *misleading advertising:* Misleading advertising is restrained by many regulations that require full and fair information in advertisements by insurance companies and agents

Figure 5–2 Avoiding Insurance Fraud

FIGHT FAKE INSURANCE
Stop. Call. Confirm.
Fake Insurance Consumer Awareness Tips

Take the following steps to avoid becoming a victim of a fake insurance scam:

- When you are offered a policy, call the Department of Insurance [in your state] and check to see if your agent is licensed, and if the insurance company is legitimate.
- Never pay cash!
- Don't be pressured into signing anything you do not understand.
- Look for "red flags," such as high-pressure marketing tactics or an extreme sense of urgency. Be skeptical of sales pitches contending that you "must act now," or those that say, "this is a one-time offer."
- Be wary of policies pushed by high-pressure newspaper ads, fax flyer solicitations, hotel sales meetings, and via internet marketing.
- Ask questions! If the sales agent or representative is evasive, that's a warning signal. Make sure you get all of the important information about the policy.
- Be aware of premiums that are at least 25 percent below the average price for comparable insurance products.
- After you purchase your policy, call the Insurance Company to verify the company and your insurance policy number. Call the Insurance Company if you have not received your policy within 30 days.
- "Fake health insurance" is difficult to manage and more often than not, the advertising clearly states that "this is not insurance." Consumers and small business owners must read the fine print to avoid scams.
- With rising health care costs a big concern, fraudulent health insurance plans thrive by victimizing small businesses and consumers.
- Illegal discount health cards and plans are also widely offered to the public through newspaper ads, flyer solicitations, hotel sales meetings, and via the internet.
- The premise is that the buyer usually pays a one-time or monthly fee and, in return, will receive a discount off the medical practitioner's normal fee by simply presenting the card. Generally, a list of practitioners is part of the process.
- Bottom line: If it seems too good to be true, it probably is!

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The insurance commissioner has broad powers to prevent unfair practices. The commissioner exercises this authority by investigating complaints, as well as by initiating investigations of any questionable acts of insurance companies or their representatives. Any individual or organization found to have violated an unfair trade practices act is subject to penalties that include fines and suspension or revocation of a license.

unauthorized entity

Licensed insurance agents are responsible for ascertaining that the carriers for which they are selling are approved by the department of insurance in that state. Any agent who sells coverage from an unauthorized entity faces the risk of regulatory penalties, liability for unpaid claims, and imprisonment on a felony charge. An *unauthorized entity* is an insurance company (or other organization either real or fictitious) that has not gained approval to place insurance business from a department of insurance in the jurisdiction where it or a producer wants to sell insurance.

To help consumers avoid buying insurance from unauthorized entities, the California state insurance department has provided the tips in Figure 5-2.[33]

Unfair Claims Practices

An insurer's practices in adjusting claims represent a major source of possible mistreatment of insureds and other claimants. Most states have laws patterned after the NAIC's model laws and regulations pertaining to unfair claim settlement practices. Some of the practices that are regarded as unfair are the following:

- failing to investigate claims promptly
- failing to communicate with or acknowledge communications from clients on a timely basis
- failing to provide a reasonable explanation as to why a claim was denied
- failing to maintain procedures for handling complaints about claims
- misrepresenting pertinent policy provisions that affect claims
- failing to try to settle a claim once the insurer's liability becomes clear
- attempting to settle a claim for far less than a reasonable person would expect based on the insurer's advertising material

Other Areas of Consumer Protection

In some lines of insurance, insurers are required to use policies that meet specified readability standards. These standards relate not just to the size of the print font used but also to expressing policy provisions in terms that a typical high school graduate should understand. Some states require that insurance consumers be given shopper's guide booklets for certain lines of

33. From the California Department of Insurance Web site (www.insurance.ca.gov/0400-news/0100-press-releases/0080-2005/release085-05.cfm, accessed 9/27/06).

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insurance. These booklets help consumers make comparisons of the costs and benefits of different policies. Various state insurance departments also publish an abundance of consumer information on their Web pages.

Taxation

premium tax

Like other businesses, insurance companies are subject to federal income taxation. Insurers are also required to pay a *premium tax* to the state, usually at a rate of about 2 percent of the gross premiums policyowners pay. This premium tax resembles a sales tax on insurance premiums. Although insurers pay the tax, its cost, of course, is built into the price of insurance and thus is paid by the policyowners.

Premium taxes primarily generate revenue for the state rather than pay for the cost of insurance regulation. The state premium tax usually goes into the state's general revenue fund, with insurance department expenses being based on separate appropriations from that fund. Only a small percentage of the total tax revenue and fees is used to operate the state insurance department.

Rehabilitation and Liquidation of Insurers

The insurance commissioner of a state not only officiates at the birth and oversees the ongoing operation of an insurer but also presides over its demise if necessary. An insurer may be liquidated for numerous reasons, including financial insolvency.

rehabilitation

The insurance commissioner acts under the insurance laws as the official in charge of supervising *rehabilitation.* Rehabilitation is the the process of restoring an insurer to financial stability through reorganization. Or the commissioner might choose *liquidation,* the process of dissolving a financially troubled insurer. The purpose of both actions is to conserve as much of the insurer's assets as possible for fair distribution to claimants, policyowners, and investors. Sometimes an insurer's license is suspended temporarily for not meeting financial solvency standards or for other noncompliance with department rulings on rates, advertising, and so on. This suspension may be a prelude to liquidation proceedings or may be a temporary action to force changes in the insurer's operations.

guaranty fund

A *guaranty fund* is a state fund designed to at least partially protect consumers against insurer insolvency. In recent years, all 50 states have adopted insurance guaranty fund plans. Model legislation promulgated by the NAIC encouraged states to adopt these laws. A "guaranty" is an agreement by which one party assumes another's debts. Guaranty funds should not be confused with guarantees, which assure the performance of a product or a service. Guaranty plans, administered on a state-by-state basis, usually assess solvent insurers in order to pay an insolvent company's unpaid claims and to return unearned premiums to its policyowners. Insurers each pay a proportional share of the losses, based on their premium volume in the state.

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To date, the guaranty funds have done a reasonably good job of protecting the consumer, and some states have adopted several improvements. These improvements concern (1) giving the guaranty funds immediate access to the insolvent insurer's assets, rather than waiting until liquidation proceedings are complete; (2) giving the guaranty funds priority over general creditors to obtain the insolvent insurer's assets; and (3) permitting a tax offset against premium taxes to solvent insurers for money paid into the guaranty funds. Even with these improvements, however, some problems remain, including lengthy delays before consumers receive their money and dollar limits on some types of claims.

Guaranty funds do not guarantee that an insurer will be able to pay its claims. A system to pay for insolvencies does not completely protect insurance buyers against insurer insolvencies. Detecting troubled insurers in advance of insolvency proceedings is an important goal. The NAIC has developed an "early warning system" based on a series of financial ratio tests. These tests have dealt mainly with the adequacy of the insurer's reserves, changes in its surplus, its rate of growth, and the adequacy of its prices. Other tools for the early detection of insurer financial difficulty include the risk-based capital standards and the on-site examination system developed by the NAIC, noted earlier in this chapter.

CURRENT FEDERAL REGULATION OF INSURANCE

This chapter emphasizes regulation of insurance by the states because most government legislation, administrative action, and court decisions that pertain to insurance have been at the state level. The McCarran-Ferguson Act reaffirmed the states' predominant role in insurance regulation. This role still continues because the law conditionally exempts insurance from such major federal statutes as the Sherman Antitrust Act (except for boycotts, coercion, or intimidation), Clayton Act, Robinson-Patman Act, and other laws. Federal laws apply only to the extent that state legislation is inadequate.

The federal government has increased its regulation of insurance in some specific and limited, but nonetheless important, areas of insurance. For example, federal agencies have regulated some aspects of interstate advertising and mergers through the Federal Trade Commission (FTC), variable life insurance and annuities through the Securities and Exchange Commission (SEC), occupational safety under various rules of the Occupational Safety and Health Administration (OSHA), and pensions and other employee benefits under the Employee Retirement Income Security Act (ERISA) administered mainly by the U.S. Department of Labor.

The Financial Services Modernization Act (Gramm-Leach-Bliley Act) which, as mentioned earlier, addresses the role of banks in insurance—is a relatively recent example of federal legislation that directly affects insurance and other financial services organizations. This act makes it clear that banking

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regulators regulate banking activities, but states continue to have primary regulatory authority for banks' insurance activities.

In October 2005, the Financial Crimes Enforcement Network (FinCEN), an agency of the United States Department of the Treasury, announced rules requiring certain U.S. insurance companies to establish anti-money-laundering programs and file suspicious-activity reports. The rules apply to insurance companies that issue or underwrite certain products that present a high degree of risk for money laundering or the financing of terrorism or other illicit activity, including the following products:

- permanent life insurance policies, other than group life insurance policies
- annuity contracts, other than group annuity contracts
- any other insurance products with cash value or investment features[34]

Money laundering involves disguising financial assets so they can be used without detection of the illegal activity that produced them. Through money laundering, the criminal transforms the monetary proceeds derived from criminal activity into funds with an apparently legal source.[35] The concern is that money laundering can be used to finance terrorism or other illicit activity. The requirement to identify and report suspicious transactions applies only to insurance companies, not their agents or brokers. However, agents and brokers must be integrated into an insurance company's anti-money-laundering program and monitored for compliance.

In compliance with these rules, insurance companies are required to train their agents to be alert for the following "red flags" to possible money-laundering activity:

- The purchase of an insurance product that appears to be inconsistent with a customer's needs.
- Any unusual method of payment, particularly by cash or cash equivalents (when such method is, in fact, unusual).
- The purchase of an insurance product with monetary instruments in structured amounts.
- The early termination of an insurance product, especially at a cost to the customer, or where cash was tendered and/or the refund check is directed to an apparently unrelated third party.
- The transfer of the benefit of an insurance product to an apparently unrelated third party.
- Little or no concern by a customer for the investment performance of an insurance product, but much concern about the early termination features of the product.

34. "Insurance Companies Required to Establish Anti-Money Laundering Programs and File Suspicious Activity Reports," U.S. Department of the Treasury, Financial Crimes Enforcement Network, FinCen News, October 31, 2005, p. 1 (http://www.fincen.gov/ newsrelease10312005.pdf, accessed 9/27/06).
35. From the Frequently Asked Questions page of the FinCEN Web site (www.fincen.gov/af_faqs.html, accessed 9/27/06).

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- The reluctance by a customer to provide identifying information when purchasing an insurance product, or the provision of minimal or seemingly fictitious information.
- The borrowing of the maximum amount available soon after purchasing the product.[36]

FEDERAL VERSUS STATE REGULATION

Proposals to modify the insurance regulatory system are often discussed but rarely implemented. One proposal recently introduced in Congress would create an optional federal charter that would give individual insurance companies the choice to adopt a federal charter or remain with the current state regulatory system. Another recent proposal would allow nonadmitted surplus lines insurers to be regulated by a single state. Why should regulation of insurance be performed mainly by the states? Advocates of state regulation have pointed out the following reasons:

- the local nature of many insurance transactions, for which any difficulties can best be resolved on a state basis
- the reasonable success of state regulation for many years, during which insurance has become an important and sound business
- the value of regulation on a state-by-state basis, which permits gradual changes and innovations in regulation without applying them to the entire country all at once
- the NAIC's help in recommending model legislation to the states to achieve some uniformity in insurance regulation

While supporters recognize that state regulation is not perfect, they claim that federal regulation would be much worse. It would, they argue, be cumbersome, expensive, less effective, and fragmented among dozens of agencies.

Conversely, the proponents of federal regulation of insurance have criticized state regulation on many points:

- inconsistencies and lack of uniformity in regulation of insurers
- inadequate funding for the important tasks of the insurance commissioners, and the short-term and political aspects of their terms of office
- the need for greater standardization in insurance contracts to cover many interstate exposures
- the desire for increased competition to ensure availability and lower, fairer insurance prices

The threat of federal regulation wherever the states fail to perform adequately is a constant incentive to improve state insurance regulation.

36. *Federal Register* , "Rules and Regulations," Vol. 70, No. 212 (Thursday, November 3, 2005), p. 66759 (www.fincen.gov/amlforinsurancecompany.pdf, accessed 9/27/06).

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EVALUATING INSURERS

In order to properly advise clients, a planner should be aware of the various criteria that can be used in evaluating both insurance companies and insurance producers.

Criteria for Selecting an Insurer

A financial planner may assist the client in the selection of insurers. Probably the single most important criterion is the insurer's financial strength. Because an insurer's basic function is to pay claims, care must be taken to select insurers that are most likely to be able to do so. In light of the number of insolvencies and near insolvencies among insurers in recent decades, and the limitations of state insurance guaranty funds noted earlier, an insurer's claims-paying ability cannot simply be taken for granted.

The size of an insurer is not always the most relevant factor, as financial strength and size are not necessarily equivalents. Many primary insurers—especially the smaller ones—are financially strong because of reinsurance. State insurance departments can provide some current information about insurers, including records about consumer complaints against specific insurers, risk-based capital compliance, and early warning financial ratios (described earlier). Many states make this information available through the Internet. A link to state insurance department Web sites appears at the NAIC Web site, naic.org.

Several rating organizations publish the financial history, ratings, and analyses of individual insurers. These organizations include A.M. Best Company, Demotech, Fitch Ratings (formed by a merger of Duff & Phelps and Fitch IBCA), Moody's, Standard & Poor's, and Weiss Ratings. However, a few words of caution are in order:

- Criteria and methodology differ among rating organizations, so an insurer may receive different ratings from different organizations.
- A rating of "A" may sound like an excellent grade, but "A" is not necessarily the highest possible rating. Best's has two ratings higher than "A," and Standard and Poor's has five ratings higher than "A."
- Some rating organizations seem to be more generous in their ratings than others.
- Not all insurers are rated by all of the rating organizations.

In light of all of these differences, it is probably wise advice to choose insurers that have very high ratings from at least two or three of the rating organizations. It is important also to remember, however, that financial ratings are based on past performance. A good rating does not ensure that an insurer will remain solvent for years to come, and a poor rating does not always mean that the insurer is about to become insolvent.

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Insurer selection should consider willingness and ability to pay claims. Companies' attitudes toward claims may differ, and the applicant should be concerned with the company's viewpoint on technicalities, as well as the claims department's reputation for satisfactory dealings with insureds. Consumer complaint files that state insurance departments maintain can be helpful.

Service is another criterion that should be used in evaluating insurers. The insurer must be able to provide proper protection for the applicant. Does the insurer specialize in a few lines of insurance, or does it sell all coverages that the purchaser may need and want? Is the insurer experienced in offering all the contracts it will write? Will the insurer individualize contracts to meet the insurance buyer's particular needs? Does it have capacity and adequate reinsurance for the amount of insurance the buyer may require? Is it licensed in all states where the buyer needs coverage? In addition to indemnification for losses, can the insurer provide any engineering and loss prevention services that the purchaser may need? And again, what is the insurer's general attitude and reputation with regard to prompt and fair settlement of all reasonable claims?

The applicant should be interested in knowing whether the insurer is liberal with respect to underwriting. A company that is selective in underwriting may prove unsatisfactory when a consumer has a difficult situation, such as poor health or extremely hazardous business activities. Conversely, a consumer with very favorable risk characteristics may benefit by dealing with a highly selective insurer.

An important criterion in the evaluation of an insurer, of course, is the cost of its products. Cost should usually be considered and compared only after the above criteria are analyzed. Exorbitant rates are obviously undesirable. Lower rates are beneficial to the purchaser; however, rates that are too low could reflect an unduly strict attitude toward claims payment, inadequate financial reserves, restrictive policy provisions, highly selective underwriting, or minimal services.

Criteria for Selecting an Insurance Company

- Financial strength
- Attitude concerning claims payment
- Lines of coverage offered
- Service before and after a claim
- Underwriting standards
- Cost of the coverage

Initial costs are only part of the necessary analysis; final costs over a longer period of protection must be considered, including possible rate changes, dividends, assessments, or premium adjustments under some types of rating plans. In life insurance, net cost comparisons over a period such as 20 years, considering dividends, cash values, and interest factors, may be appropriate.

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Also, all insurance costs should be analyzed along with other risk management costs, such as those of loss prevention.

Criteria for Choosing an Agent or Broker

One of the most important decisions in the insurance-buying process involves selection of a competent and reliable insurance agent or broker. If an exclusive agent who represents one insurer only is chosen, this selection also determines the insurer with which business is conducted. If an independent agent is chosen, the insurance buyer often leaves the selection of the insurer up to the agent, or at least relies heavily on the agent's recommendations.

Part of the insurance premium represents commission or salary to the agent or broker. If no service or inadequate service is rendered for this part of the premium, the policyowner is paying for something he or she did not receive. If the agent or broker is only an order taker, the policyowner is getting less than full value.

Some applicants place insurance with numerous agents. Frequently, this is done to create goodwill or to distribute business among a number of friends. Sound practice suggests selecting one agent or broker, or as few as possible, to handle an entire insurance portfolio. Both the insurance buyer and the agent should prefer this practice. Most agents would rather have fewer accounts for which they are fully responsible than to participate in many accounts to which they contribute little service. Sometimes an account may be split so that one agent handles the property and liability lines and another agent the life, health, and annuity business. Regardless of the number of agents, the more information that an agent has about the client's total insurance account, the better he or she may be able to analyze the risks and recommend coordinated protection for the client's needs.

The insurance consumer or financial planner who allows friendship to govern the selection of an agent may receive inadequate protection or pay an exorbitant amount for excessive or duplicate coverages. Placing insurance only on the basis of personal friendship is as foolish as selecting a doctor, a lawyer, or an architect on that basis. Because of the complex nature of various risks, insurance coverages, and rates, the insurance agent or broker should be selected with the same care and discrimination used to choose other professional advisors.

Some buyers solicit competitive bids every year for their property and liability insurance or their group employee benefits. Lower costs for insurance may come at the price of less satisfactory service from the agent, who may not regard the policyowner as a permanent client. Policyowners have found the competitive approach detrimental because in a period of losses, a business firm may have no assurance of continued coverage and competing insurers will be reluctant to participate. Thus, insurance buyers who shop too aggressively may seriously limit their market. This is less likely to occur if an insurer may expect to recoup over a period of years losses incurred in an unfavorable year.

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From the buyer's standpoint, as well as the agent's, a long-term relationship on a professional basis seems to work best in the long run.

Choosing an agent or a broker is an essential step toward a sound insurance and risk management program. Criteria used to evaluate insurance agents and brokers include knowledge and ability, willingness, integrity and character, and representation.

Knowledge and Ability

The agent must have the background and experience necessary to identify, analyze, and treat risks properly. One method to evaluate the agent's knowledge and ability is to ask such questions as, "Are you a CFP, ChFC, CLU, or CPCU? If not, are you working toward these or other educational objectives on a regular basis?" "Are you a full-time agent?" Agents who are fully committed to the insurance business are more likely to do a really successful job for their clients by developing their professional skills and keeping abreast of rapidly changing knowledge requirements.

The insurance consumer needs a technically competent agent who performs the wide variety of services essential to proper insurance protection. These services may include understanding needs, analyzing significant possibilities of loss, finding markets, comparing alternative coverages and contracts, arranging for credit or installment payments, checking on the accuracy of classifications and rates charged, providing loss prevention or engineering services, making evaluation appraisals, seeing that claims payments are made promptly, reviewing changing needs frequently, and many other important duties.

Willingness

Is the agent willing to take the time to apply his or her knowledge conscientiously and fully evaluate all the client's needs and alternatives? If not, the client won't receive the benefit of that knowledge. The agent must take the time to see that services, including those of agency staff and insurance companies, are performed as effectively as possible.

The agent should recommend additional legal, accounting, or consulting services as needed. Loss prevention suggestions and help with filing claims are also important to the insurance buyer. The best qualified agent who is too busy to provide service is of no value to the client. The time and desire to perform necessary services must be present when the client needs them.

Integrity and Character

Willing and able agents and brokers should be able to command the policyowner's confidence and trust. Because insurance is purchased to reduce uncertainty, agents or brokers must be able to give their clients both psychological and actual security. Consumers need someone with whom they

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can identify closely in discussing their financial needs and goals. The values of agent and client, if similar, can help them establish a good rapport. The agent's age in relation to the policyowner's can be a factor in this regard, but differences in age are probably less important than differences in philosophy and lifestyle. Confidential information from the purchaser is often required to provide good insurance counseling services. Thus, the agent or broker must respect the buyer's trust with complete honesty as would a doctor, a lawyer, or an accountant.

Representation

Good agents generally do not represent weak insurers. They must represent or have contacts with one or many insurers that can provide the required protection and services for the policyowner. Ideally, all necessary coverages, including even special or unusual ones, should be available through the agent(s) at a reasonable cost. The insurer or insurers represented should be capable of writing many different kinds of insurance with a progressive attitude toward newer coverages and forms designed to meet individual buyers' particular needs.

Insurance agencies and brokerage firms vary from the individual agent to organizations that have large staffs and offer a wide range of specializations. Some agencies consist of one person, others have a half-dozen agents and office personnel, while still others have 100 or more employees and operate much like a small insurance company. These organizations differ in the services they are able to offer, their methods of doing business, and the types of insurance they handle. Frequently, the members of an agency who handle life insurance limit their activities to this field. Also, in a large agency certain persons become recognized experts in such lines as pensions, liability, workers' compensation, or surety coverages. When selecting the agent or broker, the insurance consumer should consider whether the particular agent and agency office have the needed experience and service facilities.

SOURCES FOR FURTHER IN-DEPTH STUDY

- For more detail on insurance regulation:
  - Myhr, Ann E., and Markham, James J., *Insurance Operations, Regulation, and Statutory Accounting,* 2d ed., chapter 2, Malvern, PA: American Institute for Chartered Property Casualty Underwriters, 2004. Phone 800-644-2101. Web site address aicpcu.org.
  - The National Association of Insurance Commissioners maintains a Web site, which also has links to state insurance departments, at naic.org.
- For more on insurance guaranty funds:

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- The National Conference of Insurance Guaranty Funds maintains an informative Web site at ncigf.org.

- For more on insurance company financial ratings:
  -
  - AM. Best Company publishes insurer financial ratings on the Internet at ambest.com.
  - Weiss Ratings maintains a Web site at weissratings.com.
  - Fitch Ratings maintains a Web site at fitchratings.com.
  - Demotech maintains a Web site at demotech.com.

CHAPTER REVIEW

Key Terms and Concepts

National Conference of Insurance Legislators (NCOIL)
National Association of Insurance Commissioners (NAIC)
model law
model regulation
prior approval law
file-and-use law
use-and-file law
flex-rating law
open competition
legal reserve
unearned premium reserve
loss reserve
nonadmitted asset
unfair trade practices
rebating
twisting
misappropriation
commingling of funds
unauthorized entity
premium tax
rehabilitation
guaranty fund

Review Questions

Review questions are based on the learning objectives in this chapter. Thus, a [5-3] at the end of a question means that the question is based on learning objective 5-3. If there are multiple objectives, they are all listed.

5-1. Your financial planning client asks why insurance seems to be so highly regulated. How would you explain the general purpose of insurance regulation to this client? [5-1]

5-2. Insurers participate in many activities that are forms of self-regulation. What are two ways that insurers engage in self-regulation? [5-2]

5-3. What are the three basic methods of government insurance regulation? [5-2]

5-4. What are the three key categories of state regulation of insurance? [5-3]

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5-5. How do each of the following aspects of insurer operations tend to be regulated? Point out any differences between regulation applying to life insurers and that applying to property-liability insurers.
a. contracts and forms [5-3]
b. rates [5-3]
c. reserves [5-3]
d. assets and surplus values [5-3]
e. investments [5-3]
f. agents' licensing [5-3]
g. trade practices [5-3]
h. claims practices [5-3]

5-6. Maria Rodriguez, your client, is reluctant to buy whole life insurance, because she has heard of some insurers becoming insolvent. She is concerned that her insurance company might not be able to perform its obligations by the time she dies and her heirs need the insurance proceeds. How does insurance regulation seek to protect insurance buyers like Maria when an insurance company becomes insolvent? [5-3]

5-7. What are the arguments for and against regulation of insurance by the states? [5-3]

5-8. What criteria can a financial planner use to help clients select insurers for their insurance programs? [5-4]

5-9. What criteria can a financial planner use to help clients choose reliable and competent agents or brokers for their insurance programs? [5-4]

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