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DOES REGULATION OF THE INSURANCE INDUSTRY BENEFIT CONSUMERS?

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- This session will debate the effects of insurance regulation, its impact on the market, and the net effect on the well being of consumers.
  - Product filing and approval and their effect on market innovation and response
  - Solvency standards and the flow of information
  - Disclosure requirements and the evaluation of product "quality"

MR. SHANE A. CHALKE: Before we start, I have a few comments about our topic. Why a debate on insurance regulation? Well, I've noticed, over my career, two key points about regulation in the insurance industry. First, our industry is highly regulation driven in the sense that actuaries spend very high percentages of their working life dealing with regulation, working within regulation, or trying to work around regulation. I would suspect that in my particular discipline, which is product development and product modeling, we probably spend on the order of 50-60% of our time directly addressing regulatory issues and the balance addressing what I would consider more pure business issues. The second thing that I've noticed is that the very concept of regulation of an industry is seldom debated.

I've listened to many discussions about insurance regulation that center on issues such as regulation at the state or federal level, the form and scope of regulation or what regulations ought to be, but seldom is the fundamental concept of regulation questioned, debated, or discussed. My purpose in this session is to try and raise your level of awareness about this question, and, if nothing else, to put forth the idea that there is a question to be debated, that perhaps it is not a foregone conclusion that regulation, even in a complex financial industry, is necessary. If this session turns out to be controversial, I'll consider that a point of success.

As far as the structure of this session is concerned, I would call this an informal debate. Our first panelist, who will be adopting the anti-regulation stance, is Professor Clifford Smith from the Graduate School of Business Administration at the University of Rochester. His research interests are in areas of option pricing, corporate financial policy, and financial intermediation. He is author of more than 40 papers and five books on various financial topics. Two that are of special interest to actuaries are *Toward a Positive Theory of Insurance*, published in 1982, and *Demutualization in the Insurance Industry*, published in 1987. Our second panelist, Dan McCarthy, is Consulting Actuary at the New York Office of Milliman & Robertson, specializing in various fields of endeavor depending on what hour it is; today Dan is specializing in regulation.

DR. CLIFFORD W. SMITH, JR.: When Shane first called me and asked me about participating, he characterized this as something of a debate. I thought back to my experiences in high school as a debater, thought about the purpose there and concluded, quite rapidly, that process was mainly for the benefit the participants in the debate. I was, hopefully, honing a set of thinking skills and it was more for my benefit than anybody else's that the conversation or debate was taking place. Next I thought about *Saturday Night Live* where Dan Aykroyd's first line was regularly, "Jane, you ignorant . . . ." It seemed to me that was not the appropriate model either; the main purpose of that exercise was to entertain.

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What we are trying to do is to challenge people's conventional thoughts about a set of issues that sometimes we too comfortably accept; ideally we can give you some information that you didn't have before, and we can motivate some discussion and thinking on a set of issues that otherwise wouldn't take place. If I'm going to take the negative in this informal debate on "Is Insurance Regulation Necessary?," One thing that I should be thankful for is that my father is not here. Dad seemed to get completely taken in by FDR and, in my father's opinion, God and FDR were just about equals. He naturally thinks that the government is a wonderful organization and the more the better -- if it wasn't for Roosevelt taking the government's share of GNP from under 5% to over 20% during his administration, we'd still be in a depression.

When I think back to where I first started hearing discussions of regulation, I conclude it was in an eighth grade civics class. Now, I think most people's first introduction to a discussion of regulation is probably in an eighth grade civics class. There you have teachers in front of the room in a very authoritarian position. Their college training was in education, not political science, yet these people generally do bend unsuspecting young minds into believing that government employees, (especially teachers), are basically selfless, public spirited, hard working, national heroes, (especially teachers), who are systematically overworked, underappreciated, and especially underpaid, (particularly teachers). Then the average high school graduate grows up and develops some sense of paranoia. This generally is when their brainwashing is confronted with their real-world, day-to-day activities like visiting the post office. If you had something that absolutely, positively had to be there overnight, would you turn it over to the post office or to Federal Express?

In the academic community, we've had a lot of very serious attention given to the study of regulation. What the political scientists and the political economists who have looked at regulation have done is to take a very broad view of regulation and take various regulatory agencies and regulatory bodies and groups of regulations as special cases. Coming from that tradition, I'm going to do more of the same thing. So before I try and get into a detailed discussion of the specifics of insurance regulation, I'd like to give you a little perspective on regulation in other markets to provide a more general view of regulation. Now, I could tell you that long ago, the academic economics community had, quite convincingly argued that, with no externalities, unregulated markets give efficient solutions to contracting problems and that, the kinds of contracting that go on in the insurance industry produce nothing like what an economist would label a legitimate externality. So the argument for regulation, at least at that level of abstraction, falls apart. A very clever man, George Stigler, (who spent most of his academic career at the University of Chicago before he got the Nobel Prize in economics and essentially retired), asked 25 years ago, "If regulation is so bad, why have we got so much of it?" He thus began looking at a series of regulatory bodies and regulatory decisions.

The first major regulatory institution at the federal level in the U.S. was the Interstate Commerce Commission. Now, I don't know how much you know about railroad regulation in the late 1800s, but it was regularly the case that if you tried to get a trainload of cattle from Chicago to New York City, there were five different railroads that you could ship those cattle on. Some of them would go through Pittsburgh. Some of them would go through Buffalo. Some of them would go through Toronto. There was lots of competition between Chicago and New York City, but if you wanted to ship the same cows from Chicago to Buffalo and then offload them, load them on again, and ship them from Buffalo to New York City, you could pay three, four, or even five times the price for the short hauls that you would for the long haul. Well, there were a bunch of farmers in the midwest who just got incensed at the fact that the sum of the short hauls was greater than the price of the long-haul rate. They got together, went to Washington, lobbied, and got the Interstate Commerce Commission put into place. After Congress established it, they had to figure out somebody to run it, so they turned to the railroad industry to find somebody who knew something about how to manage railroads. The senior railroad executives who wound up making up the first Interstate Commerce Commission solved the farmers' problems. They just raised the price of the long haul so that it now equaled the sum of the prices of the short hauls. This little piece of history led economists to recognize that the regulated industry is a very important player in the overall regulation process.

There's a version of analysis that's referred to as the capture hypothesis; it says that, in certain cases, a regulated industry is going to capture the regulator and that regulation is systematically going to better serve the regulated than the customers of the regulated.

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One of my favorite regulation stories is one that a former colleague of mine, Karl Brunner, liked to tell. Evidently in the 1700s, the Swiss postal service was private and it was a very profitable organization. The Swiss, who are not big regulators, went in and nationalized the postal service in the late 1700s and within five years they were running a deficit.

I've done some work with the Securities and Exchange Commission (SEC). As well as I can figure out, what happened in response to the establishment of the SEC in the Securities Act of 1934 is that they brought in a bunch of consultants from major Wall Street firms and these guys said, "We've got a mandate from Congress to churn out a lot of regulation in a hurry. We've got to prove to people we're doing something, because there are people out there who said that; the stock market fell." The economy got worse; thus the stock market must have caused the economy to get worse. (Rather than there were people on Wall Street who were forecasting the economy was going to get worse and that's the reason that stock prices fell. They got the causality all wrong.)

The SEC, codified what major Wall Street firms viewed as best practice in the industry. For a lot of years, there were a lot of people who were really happy. Congress was happy because here was an awfully high pile of regulations to point to; these guys were clearly doing something and the stuff basically worked. Members of Wall Street firms were happy, but to explain why I'd like to tell you about a study on a more recently passed piece of regulation. It has to do with the cotton dust regulation in the textile industry.

You may be familiar with the cotton dust regulation if you get involved with health insurance side of things. But there was a major, mandated reduction in the particulate level in the air. Cotton dust created something in textile workers that was like black lung disease in coal miners. There were laws passed that dramatically reduced the allowed cotton dust level. Now, a friend of mine did a study of stock-price reactions to the passage of that regulation among all the textile firms that had stock listed on the New York and American Stock Exchanges? He found that the market value of that portfolio of textile firms went up by $800 million. An early draft of his paper was entitled, "800 Million Reasons Why We've Got the Cotton Dust Standards."

It's clear from looking at the cotton dust regulation that costs were being imposed on the textile industry. But you've got Burlington Mills in that industry and you've got some mom-and-pop textile mill that's running on a shoestring. Now, economists will tell you that the people who determine price in an industry aren't the average producer in the industry -- it's the marginal producer in the industry. What that regulation systematically did was to differentially impose costs on marginal producers. This has the effect of making what economists would label inframarginal producers, (the best guys in the industry.) It makes their concern about competition from these little guys a lot smaller. In the overall competition in the marketplace for textile products in the U.S., the firms that were big enough to have shares listed on the New York and American Stock Exchanges on balance benefitted from this cotton dust standard.

It you look at bank regulation in the country, it's probably closer to insurance regulation than any other major set of regulation that I can think of. Early bank regulation was state regulation. It wasn't federal regulation. I think it's fair to say, however, that one of the reasons that banks insurance companies were both regulated by the states is that regulation had the effect of creating a scarce resource, which could then be taxed. By making this regulation state specific, that created a state-specific asset and therefore created an aspect of a tax base. You gave people in the state government a vested interest in this regulation.

Despite what an eighth grade civics perspective would have you think about the regulatory process -- that it's all consumer oriented -- you've got a set of very strong vested interests in the regulatory process. One of these interests is consumers. One of these interests are the producers in the industry. A third interest that you ignore, at your peril, is the regulator as a member of the government.

I don't doubt that regulation can do some good things. I'm not here to debate the question that regulation can't do anything well. But first, there are other private market mechanisms that could accomplish a lot of the same things. Second, regulation can, as a byproduct of the regulation, create a set of problems that didn't exist previously. When you look at a lot of the discussions about why it is important for us to be regulated, two arguments that float to the top are: first, the product is complicated; consumers don't understand it. Secondly, this is a product where you pay

money up front and the contract only pays off if some prespecified event occurs in the future, thus you've got a concern about solvency and malfeasance.

Let's look around. Apples are a complex product that the average consumer doesn't understand, at least at a level where he could explain the biochemical decomposition associated with apple digestion and how it's affected by, for example, alar treatment. Yet in the recent experience of the apple industry the whole episode was brought to the public's attention by a private organization, not a government agency. In fact, it seemed to have mounted an effective enough campaign to get alar removed from the marketplace. If you eat bad food, it can kill you; if you buy a bad insurance policy, there are some financial problems that you may run into. I think most folks would say the former is a more serious potential set of circumstances than the latter. Yet how many people do you know have a consulting dietician to go to the grocery store with them shopping for food, at least compared to the number of consumers who employ professional insurance agents in consultation with discussions about what their insurance coverage ought to be. And this is despite the fact that we've got layers of regulation to protect consumers. I challenge you to come up with a very long list of products where you get to consume them first and pay for them later. Dinner last night might qualify, but there aren't a lot of people who say, "Here, take this suit and wear it for six months and come back and pay for it later."

When you think about solvency, you raise a set of questions about monitoring the firm that's providing the service. When there's future production that's involved, you've got incentives to make credible promises to consumers that when the time comes to pay, that you're going to be willing and able to do so. One aspect of effective oversight belongs with customers. Take, for example, what you've done in the savings and loan (S&L) industry, which is to say anybody that's got an account with less than $100,000 balance in it doesn't have to worry about monitoring the organization at all. You can sign up for a 14.5% CD with absolute impunity because you know that the government has regulated this industry in such a way that you're going to get your money back -- principal plus that promised high interest rate. You remove any incentive that you might have for customers to take an active role in the monitoring of the solvency of that industry.

Now, I recognize, just as quickly as you would, that if I've got 100,000 customers out there monitoring, there's going to be a lot of wasted effort; that you're likely to get a lot of duplication of effort; that many of us are likely to focus on some easy-to-observe things and few of us have strong incentives to get into the more subtle set of issues and look at them in more detail.

But that in and of itself doesn't dictate that the solution is government regulation. We see reinsurance mechanisms regularly working in the insurance industry and there you've got a set of professional, private monitoring agents out there saying "If the financial circumstances of this firm get bad, we've reinsured some of their activities." If they have made mistakes in the underwriting side of things, we see other kinds of private insurance mechanisms that operate regularly across a whole host of activities. GMAC just put together a securitization package where they sold off a huge portfolio of low-interest rate auto loans and First Boston insured them against default risk.

MR. DANIEL J. MCCARTHY: My father would pleased to know that he has a kindred spirit in Cliff's father. I was kind of amused when Shane asked me to take part in this discussion. He and I have recently spent . . . It seems like forever, I think it was only about two-and-a-half years ago.

MR. CHALKE: No, I think it was forever.

MR. MCCARTHY: Somewhere between two and a half years and forever in a discussion about what the next nonforfeiture law might be like and it was a great puzzle to me that Shane was a part of that process. The puzzle didn't arise from qualifications, which he has an abundance, but rather from the discussions which took place in the meetings, because it became clear that Shane had never seen a nonforfeiture law that he liked, to reverse an old story, or that he ever liked. As I listened to Cliff, I concluded that the topic is probably not "Does the Regulation of the Insurance Industry Benefit Consumers?" as is advertised in the booklet, but rather "Does the Regulation of Any Industry Benefit Consumers?" and that's perhaps worth discussing also. He and I have kind of equally impossible problems, it seems to me. I could easily get into the trap of being compelled to defend all regulations that exist and all regulators. I'm not going to do either of those, notwithstanding the fact that several acquaintances of mine, who are regulators who I respect, are in the audience. They can defend themselves with a little help from me, I think.

Cliff, on the other hand, could easily be kind of compelled to defend all market excesses, no matter where. I don't know if he'd like that task any better than I would like mine. I could, in theory, try to waffle by saying, at the other extreme, "Well, I'm for regulation, but you see I'm not for current regulation. I'm for good regulation. I'm for enlightened regulation. I'm for regulation the way I would do it or the way you would do it." I think that's a cop-out also.

What I would like to do is to begin with a couple of historical reflections -- one from insurance industry history and another one from my own experience -- and then talk about three specific issues that are raised in the outline of the program in the context of a different kind of industry and see how that compares to the insurance industry. First, it's been tabulated historically that of all of the life insurance companies, and my examples, by the way, will be drawn from the life insurance industry to the extent that they're insurance related at all, and they will also be drawn from American practice. I apologize to the Canadians present for knowing little of the history of Canadian regulation.

Of all the life insurance companies that existed in 1870, fewer than half still existed in 1880. The financial panics and turmoils of the 1870s essentially drove the others out of existence and a lot of people lost a lot of money -- owners, customers, people who had jobs, a lot of people. Two things happened as a result of that. I guess I have to say to Cliff two things happened after that and it's alleged that there is a result of that. One of them is what you might call a regulatory response and the other is a market response and I think it's worth noting both of them. The regulatory response is that it's clearly observable that arising out of these panics, and I would say probably pretty well demonstrated because of them, the political figures began reacting to those situations and the complaints they heard while seeking to adopt very tight and conservative solvency standards in an effort, whether successful or not we could debate, to prevent that recurrence in the future. There was also a market response and it goes to the question of when you pay for something and when you consume it; because the market response that grew out of that was this problem, this insolvency isn't something we would have cared about except that we had paid first and since we hadn't received our annuity payments yet or hadn't died or whatever, the benefits were not received. The market response came to be called assessment insurance companies, which essentially operated on the given-just-enough-money-to-pay-this-year's-claims. We'll all assess ourselves for that, kind of as those claims arise basis, and so if we don't give those guys any money, it won't matter if they go broke. That is a phenomenon which took almost half a century to play itself out. It created a whole series of its own problems, but nonetheless it was a response to that panic.

The second historical reflection I would like to give you is from my own experience. About a decade ago, I was employed by the receiver of a bankrupt company, a bankrupt life insurance company. This company had been started in the mid-1930s in Louisiana. It grew, never became a giant, but it grew and it was a stable company and it sold a lot of life insurance in about 10 southern states; to all evidence it was reasonably well-managed, at least it delivered on its promises. It was solvent and so forth. The company changed hands in the early 1970s. Its stock was publicly traded and it wasn't too hard, given that it was a fairly small company, for one small group of people to get a handle on all that stock, which they did. They placed themselves in management and succeeded, in a very short period of time, in running that company into the ground.

I became involved because, as there were not guarantee funds in those states, something had to be done to put together some kind of a plan with the assets that were left to provide something for those policyholders. I appeared at that hearing in a state court in Louisiana about ten years ago. A number of policyholders came to the hearing and one of them stopped me after the hearing and he said, "I want to see if I understand this." He said, "We paid these people this money and we were supposed to get this benefit." And he says, "I understand your testimony. We're not going to get the full benefit." I said, "I'm sorry to say. That's right. That is the situation." And he said, "And when there's some law that basically if they take this money, they're supposed to kind of hold it on the side so they can provide for the benefits." The man was not formally well educated, but he understood the concept of a reserve, as we would use that term, really well. I said that indeed there was, but that unfortunately these people had engaged in some practice which kind of looted the company and, as a result, that money wasn't there and he wasn't going to get his benefit. He kind of nodded and he said, "Well, when I bought this policy it seemed like it was from a good person, a good company." He kind of shrugged his shoulders as if to say, that's life, and yet it was obviously a financial hardship to him.

I've encountered situations like that a couple of other times. They're not easy. Now, in a sense, they're a failure of regulation, as well as an argument for it, because there was regulation in this case. Regulation didn't stop the fraud. It sent some people to jail, but it didn't stop the fraud. Perhaps a guarantee fund would have been a good thing there. I'm not really an enthusiast of guarantee funds, by and large, for reasons that Cliff eluded to, but I think the other extreme is a little bit tough too. It's a funny pattern.

Let's take a look at the three issues that are enumerated in the program. We talk about disclosure, we talk about product filing, and we talk about solvency. I'd like to reflect on them in that order. Let's use a different industry -- something we all understand as consumers but, by and large, aren't involved in professionally. Think of yourself as going out to buy a car. You're going out to buy a car and the first thing we can deal with now is disclosure. Disclosure takes several forms. Obviously there will be the promotional literature that the company will provide to you to sell you a car of type A, B, or C. In a sense, the car itself is a disclosure item because you can look at it and you can touch it and you can sit in it and see if it's comfortable and you can probably test drive it and that sort of thing. There will also be disclosure of other forms. There's a sticker on the window, for example, that discloses some price information and also discloses, based on certain standard conditions, the kind of gas mileage that you might get out of this car. So we've got disclosure, in that sense, in that purchase situation. For a tangible product, I think most of us would say we understand. Now, to be sure, we don't understand, by and large, I would suspect, any more about the detailed workings of the car than we do about the detailed digestive processes of the apple; but nonetheless, people do think they know something about cars. For one reason or another, it has been concluded in this country, and I would say that the U.S. is not entirely a free market country, that this kind of disclosure is reasonable. When Bill White was with the State Insurance Department in New Jersey, he hypothesized that he wouldn't mind seeing a whole range of products that were not then legal in New Jersey sold if there could be a great big red stamp on them which said something like "The insurer general has determined that this product may be hazardous to your financial health. Buy at your own risk." I've always been a kind of a disclosure enthusiast because it seems to me that disclosure is preferable to other more pervasive and, in some sense, pernicious forms of regulation. It at least puts information in front of people. Whether they all then employ consultants, a concept I don't object to, to help them interpret that material is something else again.

Product filing is an interesting one. The analogy there in terms of the car is, to my way of thinking, that there are certain rules a car must meet in the U.S. or you can't sell it. For example, it's got to meet federal and sometimes state emission standards, because it's been determined that it's not a good idea to have cars pollute the air beyond a certain level. Is that good or is that bad? On balance, I'm not too terribly upset with it, but in any event it's there. I understand there are rules which require that the headlights have to be within a couple of inches, at least, a certain height above the ground so that people won't be blinded by headlights of unequal height and that sort of thing, and there's a whole series of rules, basically, which say what a car has got to do if you're going to sell it and call it a car, or sell it and even have it look like a car, I suspect, in this country. And that would be my analogy to product filing. Basically what's been said is that primarily for safety reasons in that instance, and that's probably a reasonable analogy here, that for whatever the reason the market didn't get to that point, didn't get to the point of providing most of those functions -- got to some of them to be sure, might get to others if given time -- but didn't get to all of them. And so if you go buy a car, whether you like it or not, you're going to have, for example, head restraints on seats in the front seat. Do they work? I don't know. I'm told they do. You're going to have seat belts -- not a law to use them in some places -- but it's a law to have them in the car. All these things are going to be there before that product can be sold. Do I say that that's a universal good? No. But what I'm really getting at is the kind of regulation that we talk about in the insurance industry. When we say insurance is a heavily regulated industry, I think we lose sight of the fact that lots of industries are regulated and they are regulated for purposes which are, in many respects, the same underlying purposes as the regulation of insurance?

Solvency. Well, that one is a difference and it's a difference for reasons, I think, that Cliff pointed to. I'll grant that as far as the car company is concerned, you don't get to drive the car for a few years before you pay for it. If you buy it with a loan, that's another matter, but forget the tie-in between the car companies and their own loan subsidiaries for the moment. Let's assume you pay for the car at the time you buy it. The presumption is that most of the value of that purchase is delivered to you at that point; to be sure, you may have guarantees that will

depend on the continued survival of the manufacturer, that if that car breaks within the next year you can get something fixed with no cost and so forth. But still I would argue that most of the ultimate value of the car, maybe more than that, is delivered in exchange for the money you pay at the time you drive it out of the showroom and that your interest in the subsequent solvency of the manufacturer, while not nonexistent, is secondary.

Cliff has already eluded to the fact that, whether it's an argument for regulation or not, a purchaser of a long-term financial product has a very significant interest, and I don't think this is an issue that we disagree on, in the long-term survival of the person who produced that product -- the insurance company that produced that product. Is that an argument for solvency regulation? Is it an argument for guarantee funds? How do those relate to each other? It's kind of a tricky issue. I think, as a minimum, it is an argument for solvency regulation. I guess I've theorized that with solvency regulation and disclosure I'm personally kind of easy on product questions. I wouldn't be too concerned about seeing products sold that are illegal to be sold in some states today because they don't have this or that provision in them. It seems to me that fair disclosure and fair commitment to the fact that company will be around to satisfy the obligations in that product are the key elements. We've had a lot of discussion about solvency standards over the last decade, decade-and-a-half, let's say, in the life insurance industry. First of all, a lot of the premises on which we thought we were kind of comfortably operating turned out not to hold in violent economic times, so we've looked that solvency regulation extensively over the last decade-and-a-half. I think that's been a helpful look. I think we've gotten more realistic solvency regulation. Shane referred to the fact that we either try to live with regulation or get around it. There's a little of each of those as far as solvency regulation is concerned. On balance, frankly, I think it's been a net plus. I think one of the consequences of that has been like the consequences that were referred to in an area in which I have no experience at all, which is the cotton dust story that Cliff told. In that, I believe that extensive solvency regulation will have the effect of continuing a pattern which I think actually began for underlying economic reasons; that is to say I think it will continue the concentration in the insurance industry. Now, is concentration a benefit to consumers? It seems to me that's something we need to consider. We need to consider it because in one story that we heard, a story I have no reason to doubt, it sounds like concentration may have driven up prices for various reasons. And I suppose, in theory, that might happen in the insurance industry. Certainly you can picture the case that if you had one insurer, you might not have open competition. You might not have prices that sought a true competitive level.

Nonetheless, I would argue that the consolidation of the industry, which is driven in part by regulation as well as in part by underlying forces, is a benefit to consumers; not necessarily because it produces lower prices, but because I think it produces greater assurance to consumers and because I think that in an industry where the promises are long term, frankly, driving out or reducing the influence of the marginal producer is probably a benefit to consumers. And if regulation is something that takes us down that road, and I think it's something that is partly taking us down that road, it's a constraint, but I believe that constraint, from the point of consumers, is, in the long term, of benefit.

I'm thinking about other examples of industries in which we've seen deregulation and I think there's a useful example in the airline industry. Now, I fly all the flags here. I'm not an economist. I don't know anything about the airline industry. You and I buy airline tickets and fly on planes. Somebody thought it was a good idea a while ago to deregulate, to a certain extent, the airline industry. It's interesting to me what got deregulated and what didn't. The price setting and route setting authority, as I understand it, of the Civil Aeronautics Board (CAB) was essentially removed. We've certainly seen a lot of deregulation of airline prices and of routes. I think it's basically a good thing. On the other hand, frankly, since I fly planes a lot, I'm kind of glad we still have the Federal Aviation Administration (FAA). I'm kind of glad there's still somebody up there trying to make sure that three or four planes don't try to land at once or worried about which airline is going to land before which other airline. I want somebody to deal with that question. And I'd just as soon that it be somebody who doesn't have a direct economic stake in the outcome. So the idea of separating price issues, where I'd be much more comfortable to see freer markets operate, notwithstanding some of my friends in the room who are in the business of regulating health insurance loss ratio laws, in contrast to safety regulation, which I'll analogize to solvency regulation of the insurance industry -- where I'd really like to see somebody who may take perhaps too conservative an approach, if anything. I'd rather have it lean that way, just as I'd rather have them not try to land one too many planes in a particular period of time on a particular runway. I think that's not a bad idea.

There's no question that regulation interferes with the freedom of the market and we're talking about whose benefit about consumers and producers, if you will, the owners of the enterprises, and the government itself. I have no doubt that the effect of regulation is to produce more regulation and I can get as upset about that as anybody. Regulators in the room with whom I've debated that subject, always in the context of a particular issue where I'm right and they're wrong and they won't admit it, know that. Frankly though, if that's the price that we have to pay, and there does tend to be a balancing of that price periodically. You kind of encrust things little by little by little and then something happens and you sort of pull back and start over again. I think that's a reasonable constraint, at least viewed in the abstract. In any given case, I can get very upset about it, given that we have disclosure, safety and public policy questions.

Maybe we should touch on that more. I was talking recently with a knowledgeable insurance commissioner who said that he felt that he'd be very comfortable having solvency regulation go all to the federal government -- take the states out of it entirely. I don't mean this to be a state versus federal regulation speech, but as a starting premise that's where he was. Then he said the reason that we have product rules that vary state by state is that those rules reflect public policy of the state; that is to say that the elected representatives in a particular state determine, right or wrong, what it is people in that state are or are not willing to stand for. You can create a variety of examples and you can look at state laws and see, in fact, they do differ considerably as to what products can be sold in different states. Shane remarked to me that he thought regulations should be perhaps at the town level or the street level, I think it was, so you could get it right down to the smallest possible nucleus, but state is perhaps a convenient point of discussion for this purpose. I think there was value in his comment; that is to say that public policy of a state, as reflected in what its elected representatives do, and we all sometimes wonder about that, but they do and they get elected to represent us, try to determine what the ground rules are of legitimate behavior in a particular political subdivision. I think, in the form of government we have, that that's an acceptable byproduct because I think it's more acceptable than any other byproduct I can think of. If we're going to operate by elected representatives, they ought to have a sense of what's tolerable and what's not. Then they ought to enact laws that put that in place.

What have we in conclusion? First of all, we have analogies that say, in many respects, insurance regulation isn't that different from regulation of other industries. The solvency aspect is different if we make comparisons to nonfinancial industries, but there are prudent reasons why it should be different. The disclosure aspects, the product restriction aspects, the characteristics that the product must satisfy, relate quite well to those of other industries. Does that mean that I'm defending regulation of all other industries? No. But I guess I'm saying that we can't take insurance regulation out of context, and the context is the country. I apologize, again, to the Canadians, but for my examples the country is the U.S., in the particular situation that I'm analogizing, and I would say that, for that purpose, we've basically come to at least an outline -- not all the detail -- but at least an outline of regulating insurance products which is not inconsistent, for the most part, with the way the country is operated, the way the laws are made, and the way commerce, in general, is regulated in the U.S.

As a close, you'll recall, and we all know this because we all studied it on an examination, that there was a classic Supreme Court case back in 1861 or thereabouts, *Paul vs. Virginia*, which held that insurance was not commerce. That's why it got regulated by the states. Somebody back then thought it should be regulated under the commerce clause. And as insurance was viewed in its nascence at that time, nobody thought of that as being commerce. Eighty years later, people said no, it really is commerce, but we'll allow it to be regulated the way it's been regulated up till now. I think its regulation is essentially not inconsistent with the way other commerce is regulated, given the one difference of the fact that you do pay well ahead of the time of when the benefits are paid. And overall, if I had to compare that to most of the other alternatives that have been suggested, although I would pinch myself every time I said it and say why did I say that I ever supported that, I'd probably come out where we are.

MR. CHALKE: I saw Cliff take about six lines of notes, which I think is more notes than he generally uses to teach a semester course, so I'm quite interested in what he has to say.

DR. SMITH: Well, I really want to start off by saying that I think Dan's comments are well considered. My job is a lot more fun and a lot harder because if I had some real knee-jerk responses out there to shoot at, it would be a lot easier job for me. However, I think the current circumstances will offer a more productive discussion.

The first thing that I want to agree with Dan about is to go back to his example of the personal experience that he related to you about the bankrupt insurance company that he was helping to reorganize. The term that he used that got this firm into trouble was fraud or malfeasance. Now, one thing that I will say is that every society has to have a court system. Every society has to have agents who will enforce contracts as written. I do not want to leave anyone a misimpression. If someone gave me carte blanche I would probably give the people longer jail sentences than they got. I'd also make them personally liable for financial restitution.

Contracts are things that I take very, very seriously and the court systems is something that's an important component to any well-functioning society. That said, I do want to admit that while most of the court systems that we see in this country are public, there are a few examples of private court systems. Given the operation of the public court system, we're seeing at least three examples of the use of private bodies to handle contractual disputes as opposed to turning them over to the government-provided agencies. My favorite is Judge Wopner. I think he does a fantastic job. The second is when you look at a the cases where you'll get people agreeing to submit to binding arbitration, quite frequently overseen by a retired judge. They can get a much speedier resolution of the contractual dispute and quite frequently at a much lower cost. The third example that I would point to is what we're seeing with some of the corporate restructurings, especially that firms like KKR have put together, is a fundamental technological change in the structure of leverage in U.S. corporations. If you look at what, in that business, gets referred to as mezzanine financing and you notice the fact that the strip financing that goes on in the mezzanine, what happens is they give the principals, the managers in a leveraged buyout (LBO) or a management buyout (MBO), a disproportionate share of the equity. The secured senior claim holders they'll sell to anybody. But if you're going to invest in that mezzanine, they want to make you buy strips of claims that, as this firm gets in more and more financial distress, rights pass from the old stockholders to the subordinated claim holders, these mezzanine finance claim holders. They have common interests to privately get together and reorganize the firm, not take it to federal bankruptcy court. So, again, there's a private alternative, at least in a wide range of special cases, but my fundamental argument is I'm not proposing we close down the court system and I'm not supposing that we'd be better off with fewer jail cells rather than more.

Now, I liked Dan's example of the auto industry and the distinction that he made between disclosure, product filing, and solvency. In addition to the disclosure aspects that Dan talked about, I'd just ask you to think about the last time you walked into a store. You can find racks that have nothing but car magazines on then. There is a huge amount of information that's privately produced about this somewhat unregulated commodity -- that the government is not providing that information and the government is not subsidizing the purchase of that information.

The product filing or the product characteristics that Dan referred to, I think that there's an interesting distinction to be made between the emission standards on automobiles and the product characteristics that we talk about when we look at the product filing in the insurance industry. Air pollution is something that does fall under this class of legitimate economic externalities, these third party effects. If I'm engaging in some activity that, in fact, is damaging parties that I have not established a prior contract with, there is a legitimate role for the government to step in and to change things in such a way that can make us all better off than we would have been without regulation. So while there's an analogy, I think there is a substantive difference between the emission standards for the automobiles and the product filings.

There are, however, two things that I can't help but throw in at this point, however. One is Dan says you can't buy something that looks like a car in this country without seat belts. That is a factually incorrect statement. You never saw a seat belt in an Army jeep. There's one group that's exempted from all this federal regulation and that's the federal government. You can't sue a senator for discrimination in hiring on the senator's staff. Congress explicitly exempted themselves from Equal Employment Opportunity Commission (EEOC) regulations. The government can buy fleets of vehicles that otherwise don't meet auto standards in this country.

The second point, I mentioned the SEC earlier and I said that what the SEC did was, within a very short period of time, produce a big stack of regulation that people in Congress were basically happy with and the big guys on the Street dearly loved -- because it worked, it was something to show the voting populace out there, and there was a big constituency behind it. One of the things that the regulation they promulgated in the 1930s, said was that the exchanges would operate with

fixed commission rates. Now, two things happened over the next 40 years. One was better and better computers. The price of handling trades dropped dramatically. The second thing was that there was an increasing institutionalization in a marketplace, so trades of size and volume that were never seen in the 1930s came to be commonplace in the 1960s and 1970s. That led to the development of what, on the Street was referred to, first, as the third market and then the fourth market. Basically what happened was there evolved a computer network linking large institutional traders that bypassed the New York Stock Exchange completely. Member firms on the New York Exchange were required to take every trade they handled across the floor of some exchange. The industry, en masse, went to Washington, to the SEC and said, "Please deregulate us. We can't compete with this group of people that have figured out that by not applying for membership in the New York Stock Exchange, they avoid part of the regulation that we fought tooth and nail for 30 years ago." Hence, one cost of regulation is to reduce technological change in an industry. This set of regulations on automobiles has the effect of, I would argue, reducing the rate at which technological progress takes place in the auto industry. It's probably a smaller impediment in that industry because that's turning into more of a worldwide market and you can innovate other places and then, if it works well, import it to the U.S. But this product filing regulation in the U.S. cuts down a lot on innovative kinds of contractual forms that we might otherwise see and that's a cost.

Now, finally, I want to go back to this auto example and the solvency regulation. I want to point out that Dan's example was more to the point than he was willing to admit. Look at what happened to the market price of DeLoreans the day that auto company filed for bankruptcy. The price of that car halved the day the company became insolvent.

Firms that sell products with long-term future benefits associated with them care crucially about the economic failures of those corporations. There was a recent article in *The Wall Street Journal* about the problems that the people in the marketing division of Wang were having developing an effective challenge to the job that HP, DAC and IBM were mounting. Because people have severe concerns about the long run viability of Wang, given their current financial affairs, and people say I'm not going to invest in a distributed processing system by Wang not because if Wang goes insolvent those machines evaporate, but because part of what I'm buying is the ability to get the equipment fixed if it breaks down and part of what I'm buying is a continuing commitment to development of this family of machines. If I buy an IBM system, I've got a lot more assurance that five years from now that system will evolve into something that I can't even imagine today. If I buy a Wang system, that evolution, in fact, may be short-changed. It may never go any further and my competitive position, vis-a-vis my competition that went with IBM or went with HP instead of Wang, is going to be in a competitive position that I cannot tolerate.

Now, Dan said that one of the byproducts of regulation, although he was sure the numbers would support him, was that regulation of the insurance industry in this country, was leading to more consolidation within the industry and he felt that was, on balance, a good side effect. It would enhance solvency; it would give more credibility to customers with respect to the products that were being sold. Now, if I go back to the current S&L crisis, I just don't believe that a careful look at the numbers would support the proposition that default rates by large S&Ls are substantively different from default rates by small S&Ls. In fact, the defaults by the small S&Ls aren't the ones that brought the Federal Savings and Loan Insurance Corporation (FSLIC) down.

MR. MCCARTHY: One of the interesting things that happens in a discussion like this is you become fascinated with the examples. I got to thinking about where I'd be today if, about six or seven years ago, our office had invested in Wang equipment other than IBM equipment. I heard the wonderful things about IBM and it's true, of course. They keep bringing out more and more newer and better devices. They totally ignored making them at all able to talk to the older devices they sold you seven years ago. As a result, we have today's IBM systems and yesterday's IBM systems and never the twain shall talk, let alone meet. But although I think that's of interest, it doesn't get to the point that Cliff was making, and it is an interesting point. We obviously do care, any of us who are purchasers, about the long-range viability of, I wouldn't say any, but almost any organization for whom we make sizeable purchases. There do tend to be, in some cases, market responses. In fact, the DeLorean example interested me. The predecessor of the DeLorean, you may remember, was the Brooklyn. Brooklyn was a guy who, like DeLorean, went off and built a factory. His was in Nova Scotia, I think, as opposed to in Ireland and he

manufactured several thousand cars that a certain group of cultists really kind of liked and then inevitably he tanked financially. Some guy bought the entire stock of spare parts that had been made during this course of time and now runs a business out in Ohio some place essentially providing spare parts to Brooklyn owners, so things do seem to work out in one fashion or another.

But let's look at some of the specific points in this discussion we've been having because I think they're important. I wouldn't say for a minute that regulation means a fraud doesn't happen and I recognize that Cliff wasn't saying that we shouldn't have courts. There are rules against murdering people in this country. We still seem to have a fair number of murderers. People go to jail for it, that sort of thing. I don't think that's the issue on regulation per se. I think we view contract enforcement primarily as being a matter of the courts. Contract enforcement has probably improved, if you assume that there's somebody out there other than the person who sold the product, who stands to try to make sure that happens. When we talked about large versus small enterprises, consolidation in the insurance industry and so forth -- I have no idea what the default rates among S&Ls are between large and small -- but that's not the industry we're talking about. I don't know why it's different. I do happen to know that, in that regard, this industry is different with, I believe, the single exception of Baldwin-United. I don't know of a life insurance company with more than a billion dollars in assets that has gone into insolvency certainly in my working lifetime, which gets longer every year; whereas there are large numbers of small companies that have become insolvent during that period of time. I don't know why that's different. I can't claim that's a success of regulation.

In any event, the insurance industry, despite consolidation that has taken place, is still far more diffuse and less consolidated than other industries. In fact, if you just take the individual life insurance business, which is perhaps the business most relevant to the subject we're talking about here, if you want to start listing companies to get up to half the market share, you find you have to take the top 20 to get half the market share. In the auto business, I think you could do that with two. In the soda business, you could do it with one. So I think we have a ways to go yet and, frankly, I believe that if in fact I'm right, regulation is encouraging that kind of consolidation; I don't think that's a bad thing. Maybe we all have to be concerned about fewer available employers in the future. That's of parochial interest to this group, but from a consumer's point of view, up to a point, a point that I don't think we're anywhere near yet, I wouldn't say that's a bad thing. So if it turned on the question of consolidation; I think that, in the industry we're talking about, the evidence isn't bad.

The whole discussion of private courts is interesting. I think it's a little bit tangential, but it reminded me of a private court experience I had in connection with a reinsurance agreement. Two parties, companies with whom I had worked at points in the past, were engaged in putting together a fairly complex reinsurance agreement and it was clear that it was going to turn on making some determinations of certain quantities over future time. They wrote the agreement and they recognized that somebody would need to make these determinations; would, in effect, need to be the private court. I was neither present in the room nor did I even know the discussion was going on. The agreement was written down that I was designated as the private court. They mailed me a copy of it afterwards. I agreed to serve after some discussion. The thing that fascinated me about what happened is that as we made these determinations, and we would write a letter which said we've read the treaty and we now find that, in light of events, A owes B so much money. That simply became a starting point for their own negotiations as to how they would really settle it. Frankly, the private court had very little authority in the matter, which is perhaps just as well.

Consumers, left to their own devices, as to a considerable extent they, we, as consumers are, will always make sound decisions. Regulation isn't going to change that. I wouldn't suggest for a moment that regulation will encourage people to make sound decisions. It will put some kinds of boundaries on the decisions that can be made. Many people will make sound decisions totally without regulation. Other people won't make sound decisions even with regulation. But essentially, I would say that the combination of product and solvency regulation draws some kind of a fence around the decisions that we'll allow to be made. How important is that fence? Well, for some kinds of consumers, I doubt it's very important at all. We've seen kind of a deregulation, if you will, in one form or another, of large pieces of what used to be regulated in the group insurance and group pensions business. It got deregulated by just either taking it outside of the insurance companies at all, which is an interesting example relevant to the nonmember firm thing that was talked about, or we've turned them into products that we've stopped calling insurance.

We've said these parties can enter into commercial contracts that aren't insurance contracts. I don't think that's a bad thing. On the other hand, I would say that the regulation in the industry exists primarily for individual purchasers who are spending amounts of money which are small from the point of view of the producer, the company, but are still sizeable from the point of view of the people spending that money and that there is an interest to the consumer and also an interest to the producer. We heard about interest of regulations of the large producer. I don't think that the interests of the producers and the interests of the consumers are totally at odds in that regard. There are always differences, obviously. If you have a buyer and a seller, it would be rare that their interests are totally parallel. Well, I don't think they're totally at odds either. That is to say I believe that there would be few, if any, insurance companies in the U.S. that would advocate for a totally unregulated environment and frankly I think that view would be not only pro-company, which it is, but also, in kind of an ironic and indirect and perhaps unintended sense, pro-consumer.

We had a discussion about when product regulation was important and when it's not and as I understand the distinction Cliff was making, the product, not designed in a certain way, could have an adverse effect on a third party; then product regulation is important because you don't expect A and B in a transaction automatically to protect C, and so it's appropriate that a regulator protect C. Well, that's kind of interesting then when we had the follow-up example of the S&Ls selling the 14.5% CD and, of course, tomorrow maybe the next one will sell a 15% CD and the next one will sell a 15.5% CD. Well, it seems to me, inevitably, when you have that kind of situation, there is a third party affected. The third party affected is going to pick up the pieces at the end and the pieces may not be the ozone layer going away. The pieces will be the layer of financial assurance that was built around those institutions going away. And whether you have formal guarantee funds or not, somebody is going to pick up those pieces and the people who pick up the pieces aren't only the people who run the companies. If they drive the company into the ground, that's the end of it. They aren't only the persons who purchased those contracts, in this case the CDs, although it will be partly them. But in one way or another, it's going to be partly you, me, and any other taxpayer who has to deal with the fall-out of that. So I would suggest to you that in large and complicated financial arenas, and the U.S. is a large and complicated financial arena, it's difficult to define a kind of transaction that doesn't have an effect on third parties. Then the obvious question is how much. If the third party effect is kind of a residual, minor thing, well perhaps it can safely be ignored. I would suggest to you that the S&L example is one that can't be ignored. In fact, we're all seeing that. We're all paying for it and we're paying for it because it's been determined not only that the guarantee funds promise shall be made good, and maybe that promise shouldn't have been made, but in effect we're paying for it beyond that. That is to say public policy determination has been made so that, what will be paid is not only what was promised in the guarantee fund, but also the whole amount, even the amounts beyond the guarantee fund.

There's an interesting comment that's been made by John Reed, the Chairman of Citicorp, who said he didn't think that proved there should not be guarantee funds, but he wanted to kind of see this thing coinsured. He wanted to have guarantee funds limited to (say) 80%, on the theory that you then provide a safety net to the consumer while at the same time getting the consumer's attention -- to encourage the consumer to differentiate between Institution A, which he thinks is sound, and Institution B, which he thinks is not. Not a bad idea. I think out of this sort of thing helpful thinking will emerge.

Finally, I would turn to the example of fixed commission rates -- an interesting example. What that says is that regulation, put in place, has to be changed and it also seems to say, if I understand Cliff's example, that once it's put in place it becomes sort of like a rock which is hard to move until the tide really builds up, and that's true. There are regulations which exist in that fashion and many of them exist in that fashion and in times of tumult they have to move, but in times of gradual change they probably hang around a lot longer than they should. Mr. Jones and I have had discussions about regulations in the state in which we are located right now and I would maintain that some of the regulations of that state are of that type and the tide isn't quite high enough yet, but maybe we're getting there. Despite that, and it's a drawback, there's not a regulation that is all good or all bad. I think that, given the alternatives, that's a reasonable trade-off to accept and maybe it just means that those of us who, in some situations, have something to do with moving the tide have to get a little more interested a little sooner in trying to make that tidal wave move. That, to me, would produce better regulation. I think it would probably produce better regulators or more responsive regulators. But in my judgment, it would

not produce regulation in an industry which depends on long-term financial assurance not only for its prosperity, but also for its markets and its existence.

MR. CHALKE: Let me start with a question for you, Dan. I'd like to reflect just a little bit about the quality of regulatory, mandated disclosure versus the quality of disclosure that's produced by the marketplace. I'd like to start with your car example and then move to insurance. Let's suppose I want to buy a Ferrari. I go to the car dealer. Let's pretend that I want to buy this car just based on the government-mandated disclosure. So I look at the sticker on the window and I observe what it says. Well, this is a sub-compact. Well, that's interesting -- sub-compact. City mileage? Well, maybe four. Highway mileage? Seven. My God, what a horrible car!

MR. MCCARTHY: Sounds right to me.

MR. CHALKE: So I go to the Yugo dealer, perhaps. The car costs $3,900, sub-compact. Highway mileage? 49. I don't know. I would never drive one. City mileage? Still double digits I'm sure. Compare this to market-driven information, which I can get, which will describe to me, through these two shelves of magazines at the book store, many more of the more intangible qualities of what I'm purchasing. Also look at maybe the market information I can glean after purchase. If I had made a purchase about four or five years, my Ferrari would now be worth about twice what I paid for it, where a four-year old Yugo I think sells for $17.35.

Let's move over to insurance. All of us are actuaries and every one here is an absolute expert on life insurance. Well, most of us anyway own life insurance to varying degrees. How did you purchase your life insurance? Did you purchase it from the government-mandated disclosure? Did you read the policy form? I wouldn't. Policy forms are all pretty much identical because of the filing and approval process. By the way, that sub-compact car that gets four miles a gallon in the city I very much doubt could make it through the product filing process if they had one. Did you look at the policy cost and benefit statement at the front of your policy? Probably not. Probably you observed market information. Probably you looked at the rating of the company done by a private rating service. Probably you looked at sales information as far as guaranteed and current benefits. Probably you looked at the history of the company as to its ability or track record of delivering on its promises. I really doubt whether you made an insurance purchase decision based on the policy cost and benefit statement in the policy form itself. Would you like to comment on that, Dan, just to get the ball rolling here?

MR. MCCARTHY: Well, sure. First of all, you don't buy any product -- cars, insurance or any other -- kind of behind a screen. If I take your car example, it would be persuasive perhaps if I wasn't at the same time allowed to look at these things and sit in the car and take a test drive and that sort of thing and I wouldn't suggest anything is a substitute for that, but it strikes me that your insurance example, Shane, is actually more off base than the car example.

MR. CHALKE: I never said I was an insurance expert.

MR. MCCARTHY: In saying that you didn't need to read the policy form because they're all the same anyway, you're saying, in effect, that you're relying on the policy form regulation; so it seems to me that that's the only reason you didn't read the policy form. You said you wanted to see the illustration of guaranteed and current benefits. It's my experience, for the kinds of products that I believe you're thinking about, that, by and large and right or wrong, states require disclosure of that table of guaranteed and current benefits. So it seems to me you're relying on the regulatory system that you're trying to kick around here.

MR. CHALKE: Gee, Stan, I guess you're right.

MR. MCCARTHY: He's always been a softie.

MR. CHALKE: Do we have any questions?

MR. NATHAN F. JONES: Dan brought marketing regulation in way at the end, which wasn't mentioned all the way through and I would like to say something about that, because it relates to some other things that were said. I was amazed to hear from Professor Smith that some consumers retain consultants known as agents. If it's not too awful to bring in the competition, Dan, you know that Jim Anderson has said that the customer of the insurance company is not the

policyholder, but the agent and at least if it's an agency distribution system, which most are in this country. And every day I see things, as Dan knows, which indicate that. I also get telephone calls from policyholders and sometimes from prospects, which are particularly illuminating to me because I've been in this business 51 years and most of those telephone calls I've had in the last eight years, since I've been at the department. I'm Nathan Jones of the New York Insurance Department. The policyholders bear out what Jim Anderson says in an indirect way and they look on it differently than you people have talked about. In general, they feel that an insurance agent is like a doctor or a lawyer, or if I may dare mention it, a clergyman or an accountant. They're professionals who should be able to be relied upon. Of course they don't think of them as in the same class. They know better. Most consumers know better. And that's a pity because all of us in this room could give the names of agents who are in that class. There are far too many agents in the first place. In the second place, an awful lot of them are... Well, some of them are criminals really, but very, very few. Most of them are so ignorant and ill-qualified, and I think I could say most, but that still leaves room for thousands who are very qualified and very able and if the consumers could only buy their insurance from them, then we'd all be much better off, I think, and that's the way that consumers look at it. They say, "You're in the state insurance department. Doesn't the insurance department regulate agents and say what they can do and make sure they're qualified?" And I guess I'll stop on that. If I were going to enter into the debate, I could say, Dan, I don't think I'm such an authority on *Paul vs. Virginia*, but I'm a much better authority than you based on what you said.

The last thing is that Jim Anderson down in Washington in May, again the opposition, said that he favored benign regulation and he was asked to define it. Jim was describing the kind of regulation that they had in the U.K. for many years and to a large extent still have. Most of you know that he made his big reputation as Acting Managing Director of Abbey in the U.K., so he's very familiar with that. That's at one end of the spectrum of insurance regulation. The other end is found in Japan and in the Germany from which they borrowed their system of regulation; where if you want to introduce a new product, you will find that it is referred by the regulators immediately to an advisory committee consisting of your competition. That is not a very favorable way to get a new product in and where the regulators also, I think in both those countries, have no qualm about saying we don't think we need your product and, what's more, we don't need your company. We've got enough of both already. In this country, anybody can get into the business that can put up $6 million in New York and a somewhat smaller sum in some other state and that causes a lot of the problems, but I think probably this country is committed to it.

MR. CHALKE: Cliff, would you like to respond to Mr. Jones' comments?

DR. SMITH: Well, there were just two parts that would like to respond to. I think that the distribution system in the U.S. is very interesting to look at because there are so many different distribution channels that are employed and that seem to coexist. From my perspective as a financial economist, that's one of the aspects of the insurance industry that has always fascinated me. It seems to me that, in addition to the independent insurance agents, you've got an important, although in some dimension, small component of that marketing distribution system that are insurance brokers. I would argue that brokers regularly get involved with the aspects of insurance policies that are probably least regulated or least standardized in the industry. I would also argue that they are some of the most knowledgeable people that you're likely to run into in the distribution system; that some form of economic Darwinism weeds out bad, ill-informed, fraudulent brokers quite quickly. Repeat business is quite important there.

We're up here speculating about the world being different. So saying something about how the world looks today in the face of this regulation is not necessarily the best evidence if you want to step outside the system and speculate about how it would differ.

The second point is about benign regulation. I want to tie that back to something that Dan said because I think that there is a big part of what the state insurance regulators do that fulfills what I would call the legitimate role that I laid out for a court system to fulfill. Although we don't call insurance regulators judges and we don't call that arena a court if you look past the names, and look at the function, there is much that falls within this legitimate contract enforcement function and thus is likely to benefit the consumers in this country. Again, I want to emphasize that I have no quarrel with the aspect of the process that says if we enter into a contract, you're going to hold

our feet to the fire and make us live up to that contract, even if it's particularly painful for one or the other of us to do so.

MR. MCCARTHY: Nate, I think there's a particularly important thing in what you said, which points to the relationship between the regulatory structure that we have for the insurance industry in the U.S. and the nature of that industry. I mean both the array of companies, of sales people, and all that kind of thing. You use the British example as kind of a counterpoint, at least until very recent years, it was a very small number of companies, most were of significant size, and benign regulation, as you described Jim's characterization of it -- was what they had and as near as I can gauge, at least for certain economic times, it seemed to work pretty well. I would say to you that if we had 50 insurance companies in the U.S. rather than 2,000 -- although there really aren't 2,000 separate entities if you stop to analyze them -- we'd have a different regulatory system and so there is a trade-off between the industry as it has shaped up and regulations that exist around that and a trade-off you could make to say, well, we're going to have rules such that there can only be a few of you guys, and then things would be very different. I don't think that's going to happen, as you don't, not in any quick way, we've really got a structure that arose out of the social and economic insurance situation in which we find ourselves. I think that's an important fact to bring out. I should have brought it out more clearly than I did and I'm glad you did.

DR. SMITH: I think that there's a substantive difference when you talk about either long-term term life or whole-life policies and short-term life policies, (especially most group life policies which are essentially renegotiated annually). Historically, the places where regulations have tended to arise is where there's a long-term commitment to a relationship and there's less in the way of repeat sales. There's much less regulation of the lettuce sold in a grocery store than there is of the auto industry and less in the auto industry than there is in the insurance or banking industry. Part of that has to do with the fact that if I go to a grocery store and I get lousy vegetables, I don't come back; and if I enter into a one-year policy as the manager that's in charge of employee benefits at Kodak or at the University of Rochester and that carrier gives me lousy service, I'm going to put this stuff up for bid next year. I'm going to move on and I think that private markets can much more easily take care of problems in short-term stuff policies, especially when you point to the magnitude of these policies that are groups policies. I'd argue that the decision maker there is rarely the ultimate insured; the important decision maker there is another specialist who's a professional manager in the corporation that's worrying about this aspect of an employee benefits package.

MR. MCCARTHY: I would agree totally. If you look at the group health business, more than half of what we used to call group health insurance isn't insured any more. It's simply private reimbursement transactions and the only reason that hasn't happened in the life business is an oddity in the federal state tax law. And were it not for that, we wouldn't have as much group life insurance, in the technical sense, as we do. It would be treated the way group health is -- on a service basis only -- so I would agree with that fully.

MR. CHALKE: By the way, I was just reading Robert Poole's book on regulation and there are more than 70,000 regulations pertaining to the sale and marketing of hamburger. I don't know if lettuce is similar, but probably only about 10% of these regulations are ever complied with because no one can possibly know 70,000 regulations.

MR. JAMES R. SWENSON: I'm with the Oregon Department of Insurance and I must say that I feel somewhat like Rodney Dangerfield; because our department, several years before I joined them, made the decision to purchase Wang computer equipment. We're holding our breath at the present time. Basically, I just wanted to share my perceptions. I've only been in the regulatory environment for a couple of years, having been in industry previously. Basically, as I perceive the industry, 98% of the players in the industry and probably 100% of those in this room are, I think, doing a fair and credible job on behalf of the consumer and our job, as a regulator, is to try to address the 2% of the people who would want to get into the business perhaps to take advantage of the consumer. One of the great difficulties with the insurance product is that it is complex and also it is very long term. Unlike the lettuce, you can't make a decision the very next day to go out and purchase a new head of lettuce at another grocer. Secondly, I think our job is to try to create a level playing field for the 98% of the players who are, indeed, doing the job effectively and to try to regulate that in a fair and equitable manner. I think the problem, frankly, is that we spend far too much of the time with respect to the latter; creating the fair and level playing field for the 98% of the credible players and we don't spend as much time trying to keep the bandits out of

the industry. Incidentally, one of the concerns that we have is that the same folks who brought you the S&L crisis, I understand, are now targeting the insurance industry as the next opportunity, if you will, in which to make a few bucks. I think when all is said and done, we, as regulators, and the actuarial body need to work very closely in a collaborative relationship to try to protect the consumers and if we, as regulators, do spend too much time trying to create the level playing field, just think of all the full employment opportunities that it creates for this profession.