



2008-PB-01
February 2008

Cross-accountability in Insurance Regulation

W. Jean Kwon

Abstract: Debates continue among Congressional members and industry leaders regarding the form of insurance regulation in the U.S. Regardless the form of regulation they support – state regulation, national regulation or optional federal chartering – they all agree that the insurance industry must be subject to close regulation/supervision, that the regulation must be effective, and that the regulatory agency must be efficient. Nevertheless, most of the bills submitted in recent years seem to reflect mainly the political motives or business objectives of politicians and industry leaders, respectively. They fail to recognize why regulation exists and who must be ultimate beneficiaries of the regulation in the insurance market. This paper attempts to offer answers to these questions. Particularly, the author discusses the importance of insurance regulation from a theoretical perspective and by examining the objectives stipulated in the insurance acts and regulations of selected jurisdictions. The discussion focuses on market (conduct) regulation, as the measures in this area are less structured than in prudent (financial and accounting) regulation. The author concludes that all parties of interest – the regulator, the insurance company (and the intermediary) and the consumer – need recognize the importance of cross-accountability to each other for the development of sound insurance market. The author recommends that the government self-regulates its quality of consumer services to improve regulatory efficiency, the insurance company implements an effective internal risk management program to minimize conflicts with clients (or cases of malpractices), and the customer learns that he or she bears the consequences of poor decisions for insurance consumption.

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Keywords: Insurance, Market (Conduct) Regulation, Federal Optional Chartering, Consumer Protection

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I. Introduction

In a previous study, Kwon (2007) examined issues related to the reform of insurance regulation in the United States. He compared regulatory structures in selected countries, investigated the political history of insurance regulation in the U.S. to identify the motives behind each call for reform, and evaluated the current state-based approach along with proposed alternatives (i.e., federal regulation and optional federal chartering). He concluded that the current state-based system had not failed and continued to show signs of efficiency improvement. To earn more support of the system by all parties of interest, however, state regulators must eliminate any bureaucratic duplications in procedure (e.g., statewide differences in insurance business application) and consolidate their activities using a centralized entity (e.g., a reformed National Association of Insurance Commissioners (NAIC)). He also recommended that regulation should exist primarily to benefit the general public, particularly policyholders.

Several new bills are submitted during the 110th Congress. For example, the NAIC, which represents state insurance commissioners, proposes the Federal Standardization Act of 2008.¹ The act calls for more standardization among state regulators than now via a single convention (not necessarily the NAIC).

The National Conference of Insurance Legislators (NCOIL) expresses its interest in the reform of insurance regulation. Notably, it has completed “A Study on State Authority: Making a Case for Proper Insurance Oversight” (Schacht et al., 2007) and, following the recommendations of the study, created a subcommittee to oversee state insurance departments and the NAIC (NCOIL, 2007).

The State of New York adds a new chapter to the reform debate.² It recently created the New York State Commission to Modernize the Regulation of Financial Services. The committee is asked to examine the feasibility of creating a single regulatory authority for banking, investment and insurance within the state, thereby implicitly opposing optional federal charter alternatives.³ The committee is expected to recommend means for “principle-guided regulation” that promotes competition while effectively protecting consumers in the financial services market.⁴ For the insurance market, the state has already issued ten principles each for the regulator and the regulated (see Table 1). The principles, particularly for the regulator, are in line with the core principles issued by the International Association of Insurance Supervisors (IAIS, 2003).⁵ They are also in line with the European Union (EU) Solvency II approach.⁶

¹ See (Connolly, 2007) for a summary of the proposal.

² Separately, the U.S. federal government examines the multifaceted regulatory structure in the financial services market – particularly given the rise in complexity of the products and the increase in the number of financial conglomerates – and investigates the possibility of introducing a single regulatory authority for the supervision of banking, investment and insurance (life business only) (GAO, 2007).

³ See Skipper and Kwon (2007) as well as Nurullah and Nakajima (2005) for differences in regulatory structures internationally.

⁴ What New York plans to achieve seems similar to the three means of for better regulation by the Financial Supervisory Authority (FSA) of the U.K. The three means are: a stronger probability that statutory outcomes are secured; lower cost; and more stimuli to competition and innovation (Tiner, 2006). The FSA also introduced 11 principles.

⁵ Selected Insurance Core Principles are as follows: ICP 3 (the authority being “operationally independent and accountable in the exercise of its functions and powers”); ICP 4 (the authority conducting

Table 1: Principles for Insurance Regulation (New York)

The Licensee Shall:	The Regulator Shall:
<ul style="list-style-type: none"> ○ Lawfully conduct its business with integrity, due skills and diligence. ○ Organize and control its affairs responsibly and effectively, with adequate risk management systems. ○ Maintain adequate financial resources. ○ Pay due regard to the interests of its clients and treat them fairly. ○ Respect the information needs of clients and communicate information to them in a way that is clear, fair and not misleading. ○ Manage conflicts of interest fairly, both between the licensee and its clients and between clients. ○ Ensure the appropriateness or suitability of its advice and discretionary decisions for any person or other entity that is entitled to rely upon such. ○ Ensure the assets of any client for which the licensee is responsible are adequately protected. ○ Interact with the superintendent and other regulators in an open and cooperative way, and disclose to the superintendent any information relating to the licensee of which the superintendent would reasonably expect notice. 	<ul style="list-style-type: none"> ○ Assess risk comprehensively and concentrate resources on the most important areas. ○ Be accountable for the efficiency and effectiveness of their activities while remaining independent and objective in the decisions they make. ○ Offer guidance that is readily available and easily understood. ○ Consult interested parties as appropriate prior to issuance of written guidance by the regulator. ○ Consider how new regulations can be implemented and enforced using existing systems and data to minimize the administrative burden on regulated entities. ○ Not launch an investigation or inquiry without an appropriate basis. ○ Not require unnecessary or needlessly duplicate information from a regulated entity. ○ Be proportionate in all regulatory action to the issue being addressed. ○ Allow and encourage competition and innovation while ensuring against insolvency and protecting consumers and markets, and only intervene as necessary to protect consumers and markets. ○ Respect management’s responsibility for ensuring that its business complies with requirements and hold senior management responsible for risk management and controls.

Source: New York State Insurance Department (2007).

The principles also share some commonalities with the positions that other politicians and industry leaders hold in that they all emphasize the importance of protecting consumer rights and interests. This should not be surprising. Nonetheless, *are the (U.S. state) regulators indeed doing their best for the protection of policyholders’ interests?*

Insurance is purchased in utmost good faith, and consumers rely on the integrity of the insurers with which they deal. However, the complex nature of this future-deliverable product affords the

“its functions in a transparent and accountable manner”); ICP 10 (insurers having “in place internal controls” and the oversight and reporting systems “allowing the board and management to monitor and control the operations”); and ICP 18 (the authority requiring “insurers to recognize the range of risks that they face and to assess and manage them effectively”).

⁶ This E.U. approach has three pillars, dealing with: (1) the financial resources that the insurer needs to stay solvent; (2) the framework for supervisory control and powers as well as responsibilities of the supervisor; and (3) risk disclosure requirements and transparency.

easy potential abuse of customers, especially unsophisticated policyholders such as individuals and small businesses. *Are insurance companies and intermediaries truly abiding by the market conduct principles when servicing their consumers? Are consumers actively increasing their own knowledge about risks they face and about insurance they use to manage the risks?* This paper examines these important questions in depth.

The structure of this paper is as follows. Section II, which follows this introductory section, examines theories of regulation with a special focus on consumer interest. Section III analyzes the duties of each party of interest in a fair and competitive market. The final section draws conclusions and recommendations.

II. Economic Regulation of Insurance

The financial intermediation process is rife with market imperfections that justify concern by consumers and government.⁷ Three of the most commonly known causes of market imperfections are market power, information asymmetry, and negative externalities. The ability of one or a few sellers or buyers to influence the price of a product or service is called market power.⁸ Externalities refer to benefits or costs that occur, for example, when a firm's production or an individual's consumption has direct and uncompensated effects on others. If others benefit, we have a positive externality. If costs are imposed on others, we have a negative externality. Societal risk management is particularly concerned about negative externalities.

Information problems occur when buyers (or sellers) lack sufficient information to make an informed purchase (or sales) decision. When consumers buy insurance, for example, they do so largely on faith. Consumers are not truly informed buyers. They hope an agency – usually the government – protects their interests and to ensure that the sellers do not take unfair advantage of them.⁹ Markets that suffer such information asymmetries often are regulated if the goods or services involved are important elements of the economy.

Information problems are of two types: asymmetric information and nonexistent information. In some instances, desired information simply does not exist. In other instances, information is available but asymmetrically to the parties of transaction. In other words, asymmetric information problems arise when one party to a transaction has relevant information that the other does not have. Information asymmetry problems can be considered as those relating primarily to the buyer and those relating primarily to the seller. The first two below relate primarily to the buyer whereas the last two relate primarily to the seller.

- A so-called “lemons” problem exists when the buyer knows less than the seller about the seller's products. Thus, the typical insurance buyer is unsure about the suitability and price of insurance policies as well as about the solidity of insurers backing the policies. Is he or she buying a “lemon?” Is the insurer (or its agent) taking advantage of the consumer's poor knowledge of insurance?

⁷ The discussion in this section is based in part on Skipper and Kwon (2007).

⁸ Several conditions can give rise to market power, including: governmentally created barriers to entry, economies of scale, and product differentiation and price discrimination.

⁹ This logic should apply to cases when consumers purchase a host of other goods and services, such as automobiles, investments and medical services.

- A principal-agent (or agency) problem exists when the buyer of services knows less about its agent's actions than does the agent.¹⁰ Similarly, the interests of the management (the "agent") of an insurance company may not always align with the interests of the company owners (the "principal"). Managers may be more interested in making money for themselves than in making profits for the firm's owners. Also, the typical insurer using agencies for product distribution cannot always depend upon its salespeople being completely forthcoming in sales situations; after all, many salespeople are interested in making the sale to secure a commission. In these and a host of other situations, inefficiencies can arise when the interests of the agent and the interests of the principal diverge.
- Adverse selection exists when the seller knows less than the buyer about the buyer's situation. The typical insurer cannot be completely sure that the applicant is disclosing all relevant information. Is the applicant withholding or misrepresenting important coverage-related information?
- Moral hazard is the propensity of individuals (and, more or less of entities) to alter their behavior when risk is transferred to a third party. For example, insureds have a tendency to alter their behavior – to be less careful – because of the existence of insurance. An extreme abuse of this position can be classified as fraud.

In each of the above instances, the adversely affected party can attempt to obtain more information to reduce the adverse consequences of the information asymmetry. An ill-informed buyer can engage in deeper research about the quality and prices of potential purchases, to reduce the chances of making a poor decision. An insurer considering the issuance of a policy can request additional information about the applicant. Its board of directors (representing the interests of the owners) can establish a stricter system of monitoring managers, and managers can tighten supervision of salespeople. The insurers can undertake deeper claims investigations to root out fraudulent or exaggerated claims.

When individuals do not have complete knowledge about the consequences of their present and future choices, they face uncertainty. This uncertainty leads them to take ameliorating actions intended to reduce their risk exposure. These offsetting actions require the expenditure of additional resources, thus decreasing overall benefits to society. Without regulation in insurance, problems of imperfect information and the conflict between policyholders (principals) and their insurers (agents) may lead to an excessive number of insolvencies and excessive insolvency costs (Klein, 2007).

Environmental factors – such as prevailing economic condition, new laws and regulations, and changing consumer attitudes and preferences – present great uncertainty to both buyers and sellers, thus rendering decision-making suboptimal. These and other like situations can be addressed, albeit not fully, through actions such as risk diversification or by creating various "safety nets" for consumers (e.g., state guaranty funds). This information asymmetry – the lemons problem – is the basis for most securities and insurance regulation, and, to a lesser extent, for banking regulation.

Theories of Regulation

We can now safely assume that regulation is a necessary, albeit not sufficient, element for sound insurance markets. Several theories also attempt to explain why regulation exists.

¹⁰ The term agent is used here in a generic sense meaning any person acting for another person (its principal).

Under the public interest theory of regulation, regulation exists to serve the public interest by protecting consumers from abuse. This regulatory theory flows directly from the goal of government seeking to rectify market imperfections. The objective is to maximize economic efficiency, including preventing or making right significant societal or consumer harm that results from market imperfections. The premise that government can rectify or ameliorate market imperfections presumes that government can correctly identify the market failure, will function for the overall public good, and will be indifferent to conflicts of interest in general and special interest group pressures. For this theory of regulation to work, the government should function as an efficient regulator.

Under private interest theories of regulation, regulation exists to promote the interests of private parties. Thus, Peltzman (1983) suggests that self-interested regulators engage in regulatory activities consistent with maximizing their political support. Under this theory, regulators might exhibit pro-industry biases to gain industry financial and other backing. Regulators might engage in activities that appeal to consumers (voters) such as price suppression to gain their support, even if the long-term effects were detrimental. Klein (2007) summarizes the potential harm resulting from the government working for private interest groups in insurance:

[R]eal world regulatory policies may be driven by the self interests of government officials and legislators to maximize their political support. When the effects of regulation are opaque to the public, regulators may favor groups with concentrated economic interests in the adoption of certain policies that will be at the expense of the broader public whose economic interests are [diffuse]. In other instances, regulators may [exhibit] public biases and preferences on highly visible issues (e.g., the cost of auto and home insurance even if the resulting policies can have long-term negative effects on consumers.

Meier (1988) asserts that regulation is shaped by a type of bargaining that occurs between private interest groups within the existing political and administrative structure. Interest groups include consumers (inclusive of consumer advocates), the regulator, political elites (courts and the legislative body) and the regulated industry. Political resources, saliency and complexity of regulatory issues determine interest group influence. These groups are not homogeneous, so bargaining outcomes vary from issue to issue.

The best-known private interest theory is the capture theory of regulation in which regulation is “captured” by and operated for the benefit of the regulated industry. Stigler (1971) and others contend that special interest groups, being well organized and well financed, influence legislation and regulation for their own benefit. Special interest groups in financial services include all financial intermediaries, agents, brokers and the firms that provide services to these industry participants.

Consumers, being widely dispersed, ill organized, poorly financed and, on a given issue, not as well informed as special interest groups, may be ineffective by comparison. Regulation unduly influenced by special interests could be expected to result in: restrictions on market entry of new domestic and especially foreign firms; suppression of price and product competition; or control of inter-industry competition from those selling similar or complementary products.

Each of these phenomena is found in financial markets to varying degrees and, under appropriate conditions, can be justified under the public interest theory. Government’s difficult task is to recognize when an interest group’s public interest arguments mask conflicting self-interest and private motivations.

When governments intervene in private markets, policymakers typically assert the need to correct or prevent some perceived harm; that is, to help rectify imperfections in the market and, thereby, to move the market toward greater efficiency and enhanced social welfare. Of course, policymakers are unlikely to use the economists’ terminology in justifying intervention, but behind

their words, lurk (or, rather, should lurk) sound economic justification. If financial markets were perfectly competitive, regulation would be unnecessary.¹¹

Generally, regulatory intervention falls into three categories: prudential regulation, market conduct regulation, and competition policy. Prudential regulation is concerned with the financial condition of the financial intermediary. Market conduct regulation refers to government prescribed rules establishing inappropriate marketing practices. Competition policy (antitrust) regulation is concerned with actions of the financial intermediary that substantially lessen competition.¹² Prudential regulation evolved primarily because of information problems and negative externalities. Market conduct regulation evolved primarily because of information asymmetry problems. Competition policy regulation evolved because of market power concerns. Thus, we can safely conclude that consumer rights can be effectively protected only if the government has in place efficient and effective prudential and market (conduct) regulation as well as competition policy.

Examination of existing theories clearly shows that practice of insurance regulation based on public interest theory is ideal. U.S. regulators aim to do so but face conflicts with other goals. For example, Kwon (2007) suggests presence of a strong tax motive in insurance regulation. He also contends that state governments seem to outsource their regulatory functions to the NAIC at the "additional" cost of the regulated insurance entities and other users of NAIC services.¹³ Ultimately, policyholders bear the additional cost burden.

Prudent regulation, like banking regulation, is focused on the monitoring and preventing (more precisely, minimizing) insolvencies. However, unlike banking regulatory solvency monitoring that aims to prevent systemic risks, insurance regulatory solvency monitoring is aimed more at protecting policyholders from losses occasioned by insurer insolvency. Minimizing insurer insolvency is not, and should not be, all about insurance regulation. Equally important is market conduct regulation designed to protect policyholders from any unfair treatment by insurers and educating consumers on the benefits and costs of insurance.¹⁴

State governments have implemented a wide array of market (conduct) regulation. Rate and policy form regulation is one example. Market practice regulation, such as transparency in sales presentation by agents and prohibition of redlining in underwriting, is another example. Consumer education is equally important. Regulators also require insurance companies to abide by fair claims practice guidelines, while helping the industry fight against fraud.

¹¹ Within a competitive market, we deem government intervention for economic purposes desirable only if all of the following three conditions exist: (1) actual or potential market imperfections exist; (2) the market imperfections do or could lead to meaningful economic inefficiency or inequity; or (3) government action can ameliorate the inefficiency or inequity. Conversely, if at least one of the three conditions is not met, no government intervention is warranted. Thus, no intervention is justified into financial service markets that exhibit no market imperfections or where imperfections exist but they do not lead to important inefficiencies or inequities. Even if market imperfections exist and they are judged to be meaningful, no intervention is justified if government's actions could not ameliorate the imperfection. After all, there is no guarantee that government intervention will be successful (or that government's assessment of the imperfection is accurate). Indeed, government intervention can make matters worse. Sometimes, the best governmental reaction is no action, even for inefficient markets.

¹² As Voss (2007) asserts, the federal and state governments have in place consumer protection, antitrust, and unfair trade practice laws that help stop anti-competitive conducts in the insurance market.

¹³ For example, the financial contribution of all U.S. states remained at 3.18% of the NAIC budget of \$63.4 million for 2007 (Barrett, 2006).

¹⁴ Policyholders should not be limited to individuals and small businesses. Large corporations can be victims of malpractice of selected insurers or intermediaries. See, for example, a summary of cases related to the big rigging scandals in Schacht et al., (2007).

III. A Fair and Competitive Insurance Market

Market (conduct) regulation certainly is part of the government's duty. However, a sound insurance market needs more than the regulation itself. It requires the cooperation of the suppliers – namely, insurance companies and their agents – and educated consumers. They bear their own duties, thus assuming the consequences from failing to meet the market expectations imposed on them. They should have right to hold the other parties accountable for their own failures. We describe below in this section the preparedness of each of the parties in the insurance market – particularly in the private sector.

The Government

Representing its members (i.e., state insurance commissioners and their deputies), the NAIC asserts that its “primary goal is to protect insurance consumers, which [it] must do proactively and aggressively” (NAIC, 2007). Insurance regulators in other countries share this goal; alternatively, the IAIS states:

The supervisory authority sets minimum requirements for insurers and intermediaries in dealing with consumers in its jurisdiction, including foreign insurers selling products on a cross-border basis. The requirements include provision of timely, complete and relevant information to consumers both before a contract is entered into through to the point at which all obligations under a contract have been satisfied. (Insurance Core Principle 25)

Governments set this goal to strengthen consumer confidence in the insurance market.¹⁵ We find several measures supporting this attempt. First, the IAIS and the NAIC as well as their members recognize the importance of an utmost good faith-based claims resolution process – including alternative dispute resolutions – to preserve the confidence. Some countries have established a judicial body to settle dispute between claimants and insurers. Examples include the Insurance Ombudsman Service in Australia, Office of the Insurance Ombudsman in India, Financial Ombudsman Service in the U.K., Office of Insurance Claims Ombudsman in New Jersey, U.S., and the Office of the Ombudsman in California, U.S.

Second, courts may treat insurance contracts as contracts of adhesion – contracts between parties of unequal bargaining power, under which consumers are commonly required to accept the terms and conditions of the contract drawn by the other party. Applying this legal principle, courts may reach a verdict in favor of the consumers when they find an element of ambiguity in the contract being disputed.

Third, regulators mandate insurers to include several standard provisions in personal insurance contracts. With the provisions of grace period and incontestability, for instance, insurers are barred from cancelling policies for nonpayment of renewal premium during the period and voiding policies after detecting a nonfraudulent, material fact or concealment after the period stipulated in the contract, respectively. Nonforfeiture and free-look period clauses are two other examples in

¹⁵ Skipper and Kwon (2007) contend that consumer protection concerns attach to insurer marketing efforts:

Where distribution is via local establishment, such as an agency, branch or subsidiary, local regulation and a national treatment standard are sufficient. However, cross-border distribution may not ensure local consumers adequate protection against marketing abuses. As with questions of contract *situs* concerning claims settlement, the issue of adequate consumer protection from marketing abuses may warrant little government concern as respects reinsurance or commercial insurance lines. In contrast, individuals are vulnerable to abuses, and a mechanism to ensure *host*-country protection may be warranted in a liberalized insurance world.

life insurance. Insurance regulators also require the contracts to be readable.¹⁶ Separately, regulators around the world are setting stringent rules on the handling by insurers and their agents of client data for the protection of private information of customers.

Finally, regulators are expected to promote the consumers' understanding of insurance and must educate consumers about the benefits and costs of insurance.¹⁷ When this rule applies, they must make available consumer guidelines using all cost-effective media and, today, the Internet so that policyholders consumers can make informed decisions. They must offer multiple communication channels, including the traditional ones for the non-Internet generation, to handle consumer complaints and inquiries. Regulators must conduct routine examinations, in part to detect market misconduct. When they fail to do so, they should be held accountable for the resulting inefficiency in the market.

Are U.S. state regulators doing their best for the protection of policyholders' interests? We may find some answers to this question from two studies by the NAIC. One is the Consumer Complaints White Paper (2000) based on the findings from a customer satisfaction survey in 1998. The other is the NAIC Consumer Services Survey (2006) in which state insurance departments participated.

The NAIC Consumer Complaints White Paper. The paper defines a complaint "any" communication, written or oral, that expresses dissatisfaction with a specific regulated entity, insurance company or agent alike.¹⁸ Thus, complaints are different from inquiries (e.g., questions about coverages and rates). It also reports that the consumer services divisions of state insurance departments are often the "initial and sometimes the only contact" that consumers have with the insurance regulatory authority.

From the survey, the NAIC found differences among states regarding the breadth of services provided and advised those non-performing states to improve their service quality. As per best practices, the paper offers several recommendations including, but not limited to, the following:

- Consumer complaints should be accepted through any mode of communication.
- All complaints should receive an initial acknowledgment within two business days. (See also Table 4.) The department should establish a procedure to ensure that a timely response is received from the respondent.
- The department should establish a database – in consistent with the NAIC Complaints Database Systems – to identify complaint trends.
- Complaint analysts should be aware of the activities that constitute an unfair claim settlement practice or unfair trade practice and the standard of review used to determine if an insurer or agent is in violation.

¹⁶ For example, the Insurance Act of New York prescribes that insurance policies subject to prior form approval of the state be "readable and understandable" and that the policies pass a Flesch reading ease test. Roughly speaking, the policies should be easily understandable by average 5th grader students.

¹⁷ Not all countries impose this responsibility on the insurance authority. For example, it is not Australian Prudential and Regulatory Authority but the Australian Competition and Consumer Commission that bears consumer protection and awareness responsibility. Similarly, the Financial Consumer Agency of Canada, a federal agency established in 2001, is responsible for consumer education and protection (Nurullah and Nakajima, 2005).

¹⁸ Most U.S. states recognized and accepted any consumer grievance as a complaint – a practice also found in the NAIC Market Conduct Examiners Handbook. However, complaints do not necessarily relate to statutory violations.

- The department should implement quality control measures to assure that complaints are handled properly.
- Since many types of complaints fall outside of insurance regulation, there has to be some understanding among the different states, among other state agencies and with deferral agencies as to what complaints are to be resolved.

The NAIC Consumer Services Survey. Forty-one U.S. jurisdictions participated in this 2006 survey, which was to investigate the functions of state consumer services representatives, state complaint handling systems, and management of consumer complaints/inquiry data. Key findings from the survey are as follows:¹⁹

- The annual number of complaints by state ranges from 250 to over 48,000. Twenty six states reported 250–6,000 such complaints for the year. Three states experienced more than 24,000 complaints. Besides, the annual number of inquiries by state ranges from under 10,000 to over 90,000.
- The annual complaint file load per investigator was up to 400 cases in 14 states, 401–600 in 15 states, 601–800 in three states, 801–1,000 in five states, and over 1,000 in seven states.
- Only 55% of the respondents process all complaints.
- Twenty-two jurisdictions handle complaints using their own consumer services staff. The remaining respondents (18 states) handle them using a decentralized manner (not specified).
- Most states sent the complaints information to the affected insurers using one or more communication modes (e.g., electronically, by fax and/or by mail). Insurers may respond to the complaints apparently by the same communication mode or modes.
- All but one participant submit data to the NAIC. However, only 26 states submit all data.
- Twenty-five states express the need for uniform standards for consumer services staff.

The 2006 NAIC study shows that state insurance departments still differ in offering services to consumers and handling consumer complaints. Even today, several state departments seemingly have failed to meet the best practice standards. Five U.S. states – Nebraska, New Mexico, Rhode Island, South Dakota and Tennessee – still do not make available state aggregate complaint data to the general public (NAIC, 2007).²⁰ The 2006 study also shows that many states still do not fully participate in the NAIC Complaints Database Systems, and one state even does not submit its data to the NAIC.²¹

¹⁹ Key findings related to NAIC services are not listed here.

²⁰ In fact, the findings of the 2006 NAIC survey are not compatible to the statistics shown in the 2006 Insurance Department Resources Report by the NAIC.

²¹ The report notes that some differences were the result of the prioritization that “must occur whenever resources are limited” in selected states.

Table 2: Full-time Equivalent Staffing (Consumer Affairs) by State (2006)

State	Supervisory Staff	Complaint Investigators	Consumer Advocates	Assistance Personnel	Health Insurance	Support Staff	Total
Alabama	–	10	–	–	–	5	15
Alaska	1	3	–	–	–	1	5
Arizona	5	–	–	11	1	3	20
Arkansas	2	7	–	–	3	6	18
California	15	53	–	44	–	17	129
Colorado	2	–	12	2	2	3	21
Connecticut	4	10	–	–	–	3	17
Delaware	3	8	–	–	3	2	16
D.C.	1	8	1	–	–	–	10
Florida	–	–	8	193	–	–	201
Georgia	5	28	–	–	–	4	37
Hawaii	–	4	–	–	–	1	5
Idaho	2	–	6	–	6.5	3	17.5
Illinois	3	20	–	1	5	2	31
Indiana	1	–	–	4	1	4	10
Iowa	1	4	8	–	7.5	2	22.5
Kansas	2	12	–	–	–	5	19
Kentucky	6	6	–	1	6	8	27
Louisiana	9	14	8	–	7	3	41
Maine	2	10	1	4	–	1	18
Maryland	10	35	2	–	7	13	67
Massachusetts	1	8	–	–	–	–	9
Michigan	2	6	–	6	4	5	23
Minnesota	2	5	–	6.5	0.5	1	15
Mississippi	3	4	–	–	–	5	12
Missouri	1	10	–	–	–	5	16
Montana	1	–	–	8	1	–	10
Nebraska	2	7	–	–	2	2.5	13.5
Nevada	1	6	–	–	–	–	7
New Hampshire	1	4	–	–	1	3	9
New Jersey	9	15	4	–	6	11	45
New Mexico	2	2	1	5	–	2	12
New York	15	60	–	–	–	33	108
North Carolina	5	19	–	8	17	9	58
North Dakota	0.5	1.5	–	3.5	1	–	6.5
Ohio	8	22	–	–	12	5.5	47.5
Oklahoma	6	7	–	6	5	14	38
Oregon	1.5	8	1	–	–	3	13.5
Pennsylvania	7	19	–	–	–	10	36
Rhode Island	1	3.5	–	–	–	1	5.5
South Carolina	1	8	–	–	–	1	10
South Dakota	1	3.5	–	–	–	1	5.5
Tennessee	3	9	–	–	–	5	17
Texas	41	30.5	–	209.1	–	25	305.6
Utah	–	5	–	–	–	3	8
Vermont	2	2	–	–	–	1	5
Virginia	8	30	1.5	–	2	9	50.5
Washington	8	–	16	–	11	9	44
West Virginia	2	2	1	10	3	5	23
Wisconsin	1	5.75	–	–	–	4	10.75
Wyoming	–	4	–	–	–	1	5
Total	210	538.75	70.5	522.1	114.5	260	1,715.85

Source: NAIC (2007), based on 2006 data.

Table 3: Workload of Consumer Services Division by State (2006)

State	Total Staff (Consumer Affairs) (1)	Total Full Time Staff (All) (2)	Share of Consumer Affairs Staff (1) ÷ (2)	Consumer Complaints (3)	Per Person Cases (3) ÷ (1)	Consumer Inquiries (4)	Per Person Cases (4) ÷ (1)
Alabama	15.0	150.6	10.0%	4,295	286	275	18
Alaska	5.0	57.0	8.8%	339	68	7,400	1,480
Arizona	20.0	142.0	14.1%	2,885	144	69,083	3,454
Arkansas	18.0	182.0	9.9%	2,721	151	27,064	1,504
California	129.0	1,337.5	9.6%	33,054	256	276,419	2,143
Colorado	21.0	81.0	25.9%	4,407	210	15,830	754
Connecticut	17.0	142.0	12.0%	5,913	348	23,373	1,375
Delaware	16.0	83.0	19.3%	9,174	573	1,960	450
D.C.	10.0	98.0	10.2%	802	80	4,500	123
Florida	201.0	2,813.0	7.1%	56,721	282	481,763	2,397
Georgia	37.0	160.0	23.1%	13,530	366	62,335	1,685
Hawaii	5.0	79.0	6.3%	684	137	6,162	1,232
Idaho	17.5	76.0	23.0%	973	56	8,308	475
Illinois	31.0	264.0	11.7%	11,487	371	185,656	5,989
Indiana	10.0	97.0	10.3%	4,414	441	57,334	5,733
Iowa	22.5	101.0	22.3%	2,303	102	1,100	49
Kansas	19.0	143.0	13.3%	4,857	256	1,696	89
Kentucky	27.0	159.0	17.0%	5,202	193	611	23
Louisiana	41.0	269.0	15.2%	8,070	197	195,748 ^a	4,774
Maine	18.0	80.5	22.4%	948	53	13,803	767
Maryland	67.0	283.0	23.7%	14,454	216	814	12
Massachusetts	9.0	126.7	7.1%	1,873	208	29,333	3,259
Michigan	23.0	129.5	17.8%	5,530	240	7,661	333
Minnesota	15.0	83.2	18.0%	2,803	187	906	60
Mississippi	12.0	80.0	15.0%	15,165	1,264	0	0
Missouri	16.0	202.5	7.9%	4,339	271	39,035	2,440
Montana	10.0	53.5	18.7%	2,310	231	600	60
Nebraska	13.5	101.5	13.3%	1,905	141	4,087	303
Nevada	7.0	74.0	9.5%	4,249	607	41,360	5,909
New Hampshire	9.0	79.8	11.3%	1,188	132	12,004	1,334
New Jersey	45.0	362.5	12.4%	7,134	159	37,522	834
New Mexico	12.0	86.0	14.0%	1,236	103	10,084	840
New York	108.0	934.0	11.6%	58,526	542	1,619	15
North Carolina	58.0	395.0	14.7%	8,245	142	71,185	1,227
North Dakota	6.5	46.5	14.0%	230	35	10,116	1,556
Ohio	47.5	293.5	16.2%	6,828	144	86,902	1,830
Oklahoma	38.0	144.5	26.3%	4,386	115	29,447	775
Oregon	13.5	90.0	15.0%	3,752	278	14,576	1,080
Pennsylvania	36.0	141.0	25.5%	18,010	500	125,714	3,492
Rhode Island	5.5	40.0	13.8%	703	128	-	0
South Carolina	10.0	80.0	12.5%	2,436	244	61,716	6,172
South Dakota	5.5	28.5	19.3%	1,019	185	19	3
Tennessee	17.0	148.0	11.5%	2,945	173	-	0
Texas	305.6	1,598.1	19.1%	27,720	91	245,472	803
Utah	8.0	82.0	9.8%	720	90	82,668	10,334
Vermont	5.0	61.0	8.2%	648	130	12,998	2,600
Virginia	50.5	208.5	24.2%	4,481	89	2,114	42
Washington	44.0	212.0	20.8%	5,831	133	113,342	2,576
West Virginia	23.0	404.0	5.7%	2,429	106	30,666	1,333
Wisconsin	10.75	132.0	8.1%	8,094	753	35,000	3,256
Wyoming	5.0	27.0	18.5%	514	103	-	0
Total	1,715.85	13,241.4	13.0%	329,482	192	2,547,380	1485

^a Louisiana (and probably Alabama, Mississippi and Texas) received a large number of complaints and inquiries as a result of hurricanes Katrina and Rita.

Source: NAIC (2007), based on 2006 data.

The NAIC reports annually consumer complaint and inquiry data by state. The data for 2006 are used for the construction of Tables 2 and 3. Table 2 shows the distribution of full-time equivalent staff within the consumer affairs division in each state. Table 3 shows the relative size of the consumer affairs division within each state insurance department. We find the sizes were low in West Virginia (5.7%), Hawaii (6.3%) and Florida (7.1%) and high in Oklahoma (26.3%), Colorado (25.9%) and Pennsylvania (25.5%). The national average was 13.0%.

Table 3 also shows the numbers of consumer complaints and inquiries – the actual numbers recorded by state and the workload per investigator. The lowest numbers of complaints per investigator were found in North Dakota (35), Maine (53) and Idaho (56), while the highest numbers are found in Mississippi (1,264), Wisconsin (753) and Nevada (607).²² The national average was 192. As per the number of inquiries, Maryland (3), New York (12) and Alabama (15) reported the lowest workload per investigator, whereas Illinois (5,989), South Carolina (6,172) and Utah (10,334) reported the highest workload. The national average was 1,485. Interestingly, Mississippi, Rhode Island, Tennessee and Wyoming recorded (or reported) no consumer inquiries for the year of 2006.

Using the NAIC data for 1990~1995, Grace and Phillips (2007) find the U.S. state average of 9,190 complaints (likely including inquiries) per year. They report the number of complaints by state ranged from 320 to 100,679 for the study period. They also offer evidence of increasing returns to scale in customer services output in largest states (in terms of budget for the insurance department). But the opposite result was found in smallest states.

Insurance regulators (should) offer customer services in part to educate customers and in part to ultimately reduce the cost of regulation.²³ For this, they need to better understand consumers and the causes and patterns of consumer dissatisfaction. Lack of knowledge about consumer behavior results in the cost of regulation being suboptimal and could further instigate arguments against state regulation.²⁴ No state or NAIC commissioned studies, except the aforementioned 1998 survey, are known to have examined this aspect. When such lack of knowledge is found to be systematic in U.S. states, other parties of interest would propose alternatives to the current regulatory structure.

The Insurance Company

Insurance companies and intermediaries are responsible for maintaining quality client services. When they fail to meet the standards set by the regulator, they can be held liable for the consequences. They may voluntarily, or as ordered by the regulator or the court, restore the financial wellbeing of the affected clients as per the terms of the contracts in force. They may be fined or their business operations can be suspended temporarily. Any insurer that commits gross malpractice may even face the risk of its business license being revoked.

²² The highest number for Mississippi in 2006 was probably a result of hurricanes Katrina and Rita.

²³ For the entire financial services sector, the U.S. federal government created the U.S. Financial Literacy and Education Commission [www.mymoney.com]. For a report on the current status of the commission, see GAO (2006).

²⁴ Evidence of federal government inefficiency in consumer services in insurance can also be found. The NAIC (2005) finds numerous problems in working with the FEMA – its Federal Insurance and Mitigation Administration that manages the National Flood Insurance Program (NFIP) – after hurricane Katrina. The problems include: delays in responding to consumer complaints and inquiries; lack of uniformity in claims estimation; poor customer service by the NFIP. The Department of Homeland Securities (2007), to which the FEMA is subordinate, also made 30 recommendations to the FEMA, including those related to information management, coordination with other federal and state agencies, employee training, and customer services.

Table 4: Time Deadlines for California Fair Claims Practices Regulations (Selected)

Requirement	Deadline
Maintain all files – open or closed for inspection by the Department of Insurance	Current year and four preceding years
Acknowledge receipt of notice of claims	15 calendar days from receipt
Respond to oral or written inquiry from the Department of Insurance	15 calendar days from receipt
After receipt of proof of claim, accept or deny the claim, in whole or in part, and affirm or deny liability	Immediately, but in no event more than 40 calendar days later
Tender payment after affirmation of coverage with respect to the first party claimant	At least 30 calendar days before the date on which the limit is to expire
If settlement is negotiated, tender payment of the negotiated amount	Immediately, but in no event more than 30 calendar days later
In claims where multiple coverage is involved, payments which are not in dispute and where the payee is known unless impairment of the insured's interest would result	Immediately, but in no event more than 30 calendar days later
Where there is a reasonable basis, supported by specific information available for review by the Department of Insurance for the belief that the claimant has submitted or caused to be submitted an insurer a suspected false or fraudulent claim	80 calendar days or suspended until otherwise ordered by the Insurance Commissioner

Source: Zalma (2007)

To establish a better claims handling environment, every U.S. state government sets claims services standards. In the state of California, for instance, “all persons” who are involved in the claims process are required to be trained properly and comply with the Fair Claims Practices Act (and Regulations). The Fair Claims Practices Regulations (introduced in 1993 and last modified in 2007) also require claims executives attest under oath that their companies abide by the regulations (Zalma, 2007). Some of the key rules of the regulations in California can be summarized as follows:

- The regulations set “minimum” standards, and the insurance company should, and is expected, to exceed the standards.
- The regulations are to promote the good faith, prompt, efficient and equitable settlement of claims on a “cost effective” basis.
- The regulations may not provide the “exclusive definition of all unfair claims settlement practices.” The state may rely also on California Insurance Code to investigate other methods, acts or practices not specified in the regulations that insurance company use in violation of the insurance code.

The Fair Claims Practices Regulations of California set time deadlines for specific acts that the regulated company must meet. Table 4 lists selected requirements found in the regulations. Unfortunately, we continue to observe evidence of customer dissatisfaction in claims handling (and underwriting) by insurance companies and their agents. Table 3 shows that consumers lodged in 2006 a total of 329,482 complaints in the aggregate of all U.S. states and the District of Columbia.

The California Insurance Department alone reported about 60,000 violations during 2000–2004 (Zalma, 2007).²⁵ For the year of 2006, the department closed 32,940 cases, resulting in a claims recovery of \$31.5 million (California Department of Insurance, 2007).²⁶ (See also Table 2.) In addition, the department conducted 271 market-conduct related examinations and helped affected customers to get premium refunds or claims payments amounting to \$46.4 million in the aggregate of all such cases in 2006. For the same year, the New York Insurance Department (2007) closed 53,211 cases. A total of 37,874 cases of them were claims-related – mostly complaints in automobile insurance (24.6%) and accident & health insurance (including Medicare and Medicaid) (64.3%).

We should not assume that the findings above and in Tables 2 and 3 represent the behavior of all insurance companies. Neither should we assume that all insurers offer low quality claims services or that all claims are with merit.²⁷ Nevertheless, the persistency in the number of claims complaints and the amount of claims recovery as a result of regulator investigation support the argument that insurers and their agents could have offered better customer services.

Table 3 offers an interesting observation. The 2,547,380 consumer inquiries lodged in 2006 imply, on the one hand, that consumers are probably willing to learn more about insurance coverages. On the other hand, the sheer number raises a question whether current practices of consumer education by the state government and insurers are ineffective, miss target consumers, or both. This is an area warranting further investigation.

The Consumer

Individuals and businesses purchase two types of insurance services in the private market. They may be required to maintain certain insurance coverage by law (e.g., automobile liability insurance and workers' compensation insurance) or by contract (e.g., mortgage life insurance). Consumers also purchase voluntarily a wide variety of other insurance products.

In a perfectly competitive market, they should live with the principle of *caveat emptor* ("let the buyer beware"); that is, they bear the risk of an uneducated decision and the consequence of it. However, the insurance market is not perfect and, even with prudent and market conduct regulation by the regulator and sound risk management plans by the regulated in place, experiences insurer insolvencies. (Of course, insurer insolvency is likely inevitable in a perfectly competitive market.)

When an insurer becomes insolvent, its policyholders and claimants may depend on the last resort such as state guaranty funds, to minimize their financial losses. However, they should not ignore the fact that they are the decision makers in most lines of insurance – life insurance, property insurance, liability insurance, automobile physical damage insurance, to name a few. Consumers should thus do their due diligence in analyzing their loss exposures and learn how to secure risk financing services only from financially and operationally sound companies.

In a market with a sufficiently large pool of educated consumers, we expect fewer claims disputes and fraudulent claims, lower cost of litigation and lower cost of regulation than in the market

²⁵ Not all state insurance departments currently offer annual customer services-related data.

²⁶ Specifically, 18,382 cases opened and 18,179 cases closed during the year were the result of claims disputes. They represent approximately 55% of the cases – whether open or closed. The other cases were related mostly to premium rating and underwriting services in the market.

²⁷ The New York State Insurance Department reports that 2,505 consumer complaints cases (about 5% of all cases) were closed in 2006 due to consumers' failure to furnish insufficient information to proceed with the cases.

where consumers merely rely on the government for the regulatory oversight of market conduct or in the event of market failure. The insurance market needs educated consumers.

Several studies cover insurance customer satisfaction issues in selected lines (e.g., health insurance in recent years) or in niche consumer sectors, but no recent studies of U.S. national scales are known. Nevertheless, we can generate some valuable inference from a recent OECD meeting.²⁸ At the meeting, Messy (2007) with the OECD offers the following findings.²⁹

- In the United States. Only 25% of homes in areas prone to flooding have flood insurance coverage. Only 12% of senior people think they are likely to need long-term care. Only 45% of consumers get suspicious about a policy that costs significantly less than comparable ones.
- In Australia. Between 21% and 81% of homeowners are underinsured by 10% or more against current rebuilding costs; others may have overlapping insurance coverages. About 65% of consumers claim good knowledge of insurance options; nevertheless, 70% expressed difficulty in understanding their particular insurance policy.
- In the United Kingdom. Only 10% of policyholders of life insurance products personally considered more than one policy. About 60% policyholders followed the advice of their intermediaries (e.g., agents and independent financial advisors).³⁰

Blancher (2007) stated that education is to enable consumers to make “appropriate financial choices” and not solely to provide information. His view was supported by Lee (2007) who found that consumer dissatisfaction about insurance products was mainly a result of the purchase of the products without correct information or appropriate understanding about the products. Lee added that nurturing appropriate professional standards among insurance agents is equally important as they remain as the first and often the only contacts with customers. The OECD meeting concluded with the following consensus regarding consumer awareness of risk and financial education.³¹

Effective education and awareness on risks and insurance issues are essential for the protection and safety of consumers and for their financial well-being as well as social and economic integration; for the sound development of competitive insurance markets; and for the efficiency of the insurance regulatory and supervisory framework. It will therefore benefit society and governments.... [For this,] public authorities... should play an active role.... Governments should seek to act at an early stage and distinguish between mere provision of information and the educational process.

Many consumers indeed do not have sufficient knowledge to make wise decisions for the consumption of financial services. There is general lack of awareness of important loss exposures and needs for insurance. Consumers tend to possess insufficient understanding of the risk management tools, certainly including insurance. Some of them do not have confidence in the insurance mechanism.

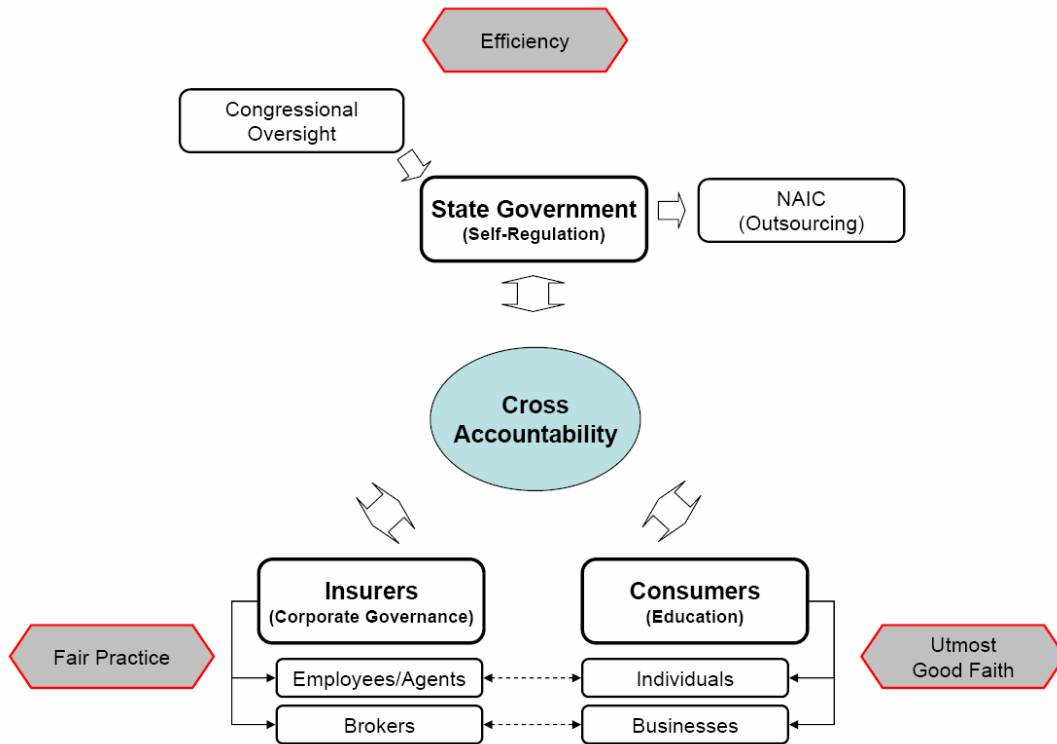
²⁸ International Seminar on Awareness and Education Relative to Risks and Insurance Issues held in Istanbul, Turkey, on April 13, 2007.

²⁹ Messy also quotes findings from a 2006 survey by *Time* magazine: 84% of U.S. citizens feel that they are not well prepared should a national disaster strikes their community; 49% do not think they live in an area at risk; 44% do not know how to prepare when a disaster strikes; 32% do not believe that preparing would help; and 27% do not have time to prepare.

³⁰ See also the Financial Services Authority (2000).

³¹ The OECD plans to publish the OECD Good Practices for Enhanced Risk Awareness and Education on Insurance Issues.

Figure 1: Cross-accountability in the Insurance Market



Federal and state government agencies offer multiple venues for consumer learning of insurance. In the U.S., about 50 U.S. institutions offer undergraduate majors risk management and insurance. Hundreds more offer insurance courses. Several universities and nonprofit organizations (e.g., Insurance Education Institute) provide high school teachers (students) with insurance teaching (learning) kits. Insurance companies and intermediaries reach out their clients. Nonetheless, it is consumers that need the knowledge for wise financial decision making. They should no longer believe that, especially at the time of national disaster, the government will always become a Good Samaritan.

IV. Cross-accountability in the Insurance Market

In this paper, we have discussed the importance of consumer education in insurance. The discussion is based on the analysis of the changes in the regulatory environment in the U.S. as well as on the theoretical aspect of insurance regulation. The discussion leads to a conclusion that both prudential regulation and market conduct regulation (as well as competition policy) play an important role for the development and furtherance of the insurance market. It seems most governments – including U.S. state governments – have developed a number of reliable means for prudent regulation. However, there is a less coordinated effort among the insurance regulators in market conduct regulation, particularly for consumer services and education.

Successful education of consumers require active participation of all parties of interest – the government, the insurance company (and the intermediaries) and the consumer. As depicted in

Figure 1, the government (inclusive of state governments and the NAIC in the case of the U.S.) must improve its regulatory efficiency. It should self-regulate itself by enforcing employee proficiency standards for its customer services staff, conduct research to identify the cohort of citizens needing more knowledge of risk and insurance, offer target-marketed education services, and make available an efficient mix of communication channels for consumers.

Insurance companies should help their employees and intermediaries obtain a sustainable level of professional proficiency, implement working internal risk management programs to minimize unnecessary conflicts with their customers, and attempt to obtain a higher level of consumer satisfaction as their business expands. Enhancing their consumer education programs, especially regarding the cost and benefit of insurance, plays an important role in this regard.

Consumers should become more active in the learning process. More of them should acknowledge that they are the decision makers when it comes to purchase of insurance products and that they will increasingly face the financial adversities when they fail to make conscientious decisions.

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