Life Insurance: Regulation as Contract Enforcement*

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April 19, 2004

Abstract

Debating the minutiae of insurance regulation without a clear understanding of why insurance companies are regulated is futile. In this non-technical essay I discuss the economic rationale for insurance business regulation. I conclude that the appropriate role of the regulator in this industry is to *enforce contracts* which would otherwise be broken. This implies that regulation should be optional, and that regulation need not be a monopoly activity.
KEY WORDS: Insurance regulation, contract enforcement.
JEL CLASSIFICATION: G22, G28.

*This paper uses ideas which I first expressed in a commentary given at the IEA/Cass Business School Financial Services Regulation Seminar Series, on 3rd March 2004. I am grateful to seminar participants for their comments, and in particular to Philip Booth.

1. Introduction

Life insurers, and mutual life insurers in particular, have in recent months attracted a great deal of attention. The U.K.'s Financial Services Authority (FSA) and its predecessors have received some severe criticism, most recently in the Penrose report into the Equitable Life's problems. While the press commentary is interesting and useful, it frequently fails to adopt a sufficiently long view of the retail financial services industry. In particular, there is surprisingly little discussion of the rationale for regulation. It seems pointless to debate regulatory policy without a clear understanding of why insurance companies are regulated. In this essay I provide a rationale: I suggest that the regulator's role should be simply to *enforce contracts* into which insurers and their customers wish to enter, but which they cannot commit to honour. This approach expands the universe of available insurance contracts and so facilitates the workings of the insurance market. It has some clear normative implications. In particular, I argue that it suggests that insurers should be regulated only to the extent that they wish to be. Furthermore, there is no clear *a priori* reason for the insurance regulator to be a monopolist.

Regulation interferes with the free operation of the market in pursuit of greater social welfare. It is a hazardous occupation: freedom of contract is a central pillar of liberal democracy. Moreover, neoclassical economics (e.g., Arrow and Hahn, 1971) confirms under some fairly restrictive assumptions Adam Smith's (1776) intuition that in helping themselves, the self-interested counterparties to a contract ensure an efficient use of resources. The Austrian school of economists have argued further than a free market fosters innovation and discovery (see for example Hayek, 1948). So we should tread very carefully when designing regulations. It is today well understood that even well-meaning attempts to alter the market process frequently have unforeseen and welfare-reductive consequences. And of course regulation need not be well-meaning: large corporate interests may capture the institutions which oversee them.[1]

This is not to imply that regulation is never necessary or desirable, but it does suggest some criteria for good regulation. Firstly, regulation should address a well-defined problem. Secondly, it should facilitate the workings of the free market and not subvert them. Finally, it should have a clearly defined scope which minimises the potential for special interests to harness regulatory power.

A large academic literature discusses the justification for and the appropriate nature of financial service regulation in the special case of banking. Banks have a special role in channelling funds from households to the productive sector; they also provide liquidity to their investors, as a result of which they are financed via demand deposits. The possibility that consumers might take advantage of their first-come-first-served contracts with the bank to precipitate a run with potentially dire systemic consequences is often

[1] The "law of unintended consequences" is so widely cited that it is hard to give a definitive reference. For a clear discussion see for example Hayek (1978). The classic discussion of regulatory capture is Stigler (1971).

cited as a justification for both deposit insurance and bank regulation.[2] The point is that extensive early withdrawals from a bank impose a cost upon remaining depositors: there is a missing market and this justifies regulation. In contrast, however, those who exit an insurance contract early bear the costs of their actions. A run on an insurance company therefore does not have the same destructive potential as a run on a bank and the arguments use to justify bank regulation do not appear to hold water in the insurance sector.[3]

2. Regulation and Disclosure Requirements

Insofar as it exists, the standard explanation for the regulation of insurance firms emphasises the importance of asymmetries of information between the insurer and its customers. For example, the FSA identifies asymmetric information as a primary regulatory concern in its most recent business plan (FSA, 2004*a*, p.8).

Asymmetric information is certainly a problem in the financial services industry. Contracts are hard to write when one party knows something the other does not. If you think that I am mis-selling but you cannot tell for sure then you will only every pay me for a poor service. And when I am paid only for a poor service then that is precisely what I will provide. The market price rationally reflects what is going on, but clearly welfare is not being maximised. The 2001 Nobel prize was awarded for pioneering work upon this type of effect.

One could interpret the driving phenomenon of the preceding paragraph as a lack of consumer confidence. It is a short step from there to the statement that regulators should maintain consumer confidence by protecting consumers from the institutions with whom they trade. This could be accomplished via the regulation of solvency levels, and of financial sales. Regrettably, this approach to regulation fails to meet the criteria introduced in the introduction. "Maintain consumer confidence" is an ill-defined objective with unclear consequences. For example, it fails to specify what level of institutional failure is consistent with consumer confidence. Freedom to define an "adequate" level of consumer confidence leaves a regulator with arbitrary power which could become the focus of rent-seeking activities by consumer and industry bodies. Moreover, any interpretation which insulates consumers from the consequences of their actions will serve to undermine the market mechanism and hence to reduce welfare.

So perhaps regulators should confine themselves to addressing the root of the informational problem. If insurers were compelled by law to provide clear information about their risk exposures and solvency levels then consumers could deploy their funds as they

[2]Wood (2003) provides a nice discussion of the liquidity role of banks; Diamond and Dybvig (1983) show how this results naturally in demand deposits and hence in bank runs. Bhattacharya, Boot and Thakor (1998) provide an academic survey of bank regulation. Lucy White and I analyse the incentive effects of bank capital regulation and of deposit insurance (Morrison and White, 2002, 2004).

[3]Bancassurance firms, formed by the merging of bank and insurance companies, raise interesting questions which I address in Morrison (2003). My concern in this essay is with the bulk of life insurance regulation, to which the arguments in the text apply.

saw fit: the allocational benefits of the free market would be restored. An elegant exposition of this idea is provided by Rees, Gravelle and Wambach (1999), who suggest that only disclosure need be regulated in the insurance markets.

This is an appealing and simple idea. It gives the regulator a precisely delineated role in responding to a clearly defined problem. We should however be careful of asserting that the appropriate response to informational problems is for the regulator simply to compel information disclosure. We must first ask ourselves why market forces will not ensure that adequate disclosure occurs. An analogous problem arises amongst the dispersed and uninformed holders of corporate bonds. Bond quality is however certified by the bond ratings agencies, and not by the State. Of course, the development of bond ratings was itself a discovery process: ratings agencies only started to assume the importance that they have today in the wake of the surprise 1970 Penn Central commercial paper default (Cantor and Packer, 1994), which highlighted the informational imbalance between borrowers and investors. As a result, borrowers today willingly pay for ratings so as to avoid asymmetric information problems.

If a regulatory agency had responded to the Penn Central default by introducing and policing disclosure requirements then the ratings agencies would not today have their important role. For two reasons, regulatory policing would probably have been less effective. Firstly, it would probably shift some of the blame for any default to the regulator from its proper place with the borrower and this would serve to diminish the managerial incentive effect of failure. Secondly, ratings agencies have nothing but their reputation for honest reporting to sustain them. They therefore seem more likely to provide dispassionate analysis than a regulatory body whose monopoly position relies upon agencies whose objectives may reflect political expediency rather than a need for transparent reporting. So if quality certification is required in the life insurance market, one might ask why it cannot be provided by a commercially-motivated delegated monitor. If it can then it is important that the regulator does not take actions which may squeeze out the third party.

In practice of course, no commercial body performs the monitoring tasks which I identify here. Nevertheless, some facts are supportive of the thesis that transparency can be generated by market institutions. For example, at the start of 2004 the U.K. mutual Standard Life was downgraded by Standard and Poor's from AA- to A+. Sesame, the U.K.'s largest independent financial adviser, responded by suspending all sales of Standard Life with-profits life insurance products.[4] Quite apart from the immediate incentive effects which this will have for Standard Life, this action may indicate an increased emphasis by customers and their representatives upon third party certification. Such an emphasis, coupled with the effects of competition, may eventually open the door to commercially generated reporting standards.

[4] "Standard Life dropped by top IFA after credit downgrade", *The Daily Telegraph*, 27th February 2004.

Notwithstanding my observations in the preceding paragraph, the market's failure hitherto to generate a greater level of transparency in the insurance markets is something of a puzzle. Why, given the complexity and importance of insurer information, is it not provided by insurers in response to competitive pressures? This point is surely fundamental to the regulation of insurance. It is closely related to the nature of life insurance contracts. The key difference between life contracts and bonds is their relative level of *liquidity* and the effect that this has upon the governance of the insurance firm and of the bond issuer.

3. Asset Liquidity and Corporate Governance

When firms raise money they make promises to their investors about the way in which they will manage their affairs. Corporate governance is largely about holding firms to these promises (see Schleifer and Vishny, 1997, for a definitive discussion). To a large extent, bond and equity holders can rely upon the market to facilitate good governance. When a poor result is disclosed investors can sell their claims on the company. The consequences of the sell-off should serve to discipline poor managers. By providing bond ratings, managers expose themselves to the discipline of the capital markets and hence commit themselves to honouring the terms of trade (or "covenants") of the bond. So a bond rating will persuade a putative bond buyer that the issuer will stick to his promises.

To see how this mechanism breaks down in the insurance market, I will consider a single consumer, Anne, who wishes to purchase life insurance. To that end, she signs a long term insurance contract today. If she exits the policy early then she will bear the costs of her decision and she knows therefore that she will stick with the policy: it is *illiquid*.

What will the consequences be for Anne of better disclosure in the life market? To be sure, it will help her to make a better entry decision: she will invest in a well-managed and well-capitalised business. But once she has contracted with her insurer she is unlikely to exit and ratings will then mostly benefit future generations of investors. Since a poor rating will not precipitate a sell-off by existing investors, disclosure requirements will not reassure Anne that the company will keep its promises.

Disclosure requirements alone are not enough to hold the insurer to its promises. Like honest behaviour, they are valuable to the insurer only insofar as they attract future investors: to put it crudely, incentives after sales are skewed to some extent away from existing customers and toward future ones. In situations where future business dries up, the insurance company is likely to rest upon its large captive pool of investors and to renege upon its promises. Insofar as poor results discourage future investors, Anne may even prefer that they are not disclosed, so that she can to some extent rely upon future investors to bail her out. It is perhaps unsurprising that disclosure has not been generated by market forces. Given its potentially deleterious effect upon future revenue streams and hence upon incentives, disclosure alone is not enough to facilitate good governance in a

life company.[5]

This discussion provides an explanation for recent expressions of concern about closed funds, and particularly for concern about closed funds in businesses which may be financially fragile. Even financially strong firms may be a source of concern if their business is generally in decline. Policy-holders may be concerned that, in the absence of future market discipline, insurance companies may elect to exert less care in the management of closed funds, or perhaps, as a Consumers' Association representative suggested in a newspaper article at the end of 2003, even to "milk" them to cross-subsidise new business.[6]

4. Time Consistency and Life Insurance

The effects outlined in the preceding section have serious economic consequences. Because she is a captive consumer, Anne anticipates that if her insurer experiences bad losses at an interim date which harm its future sales prospects it will respond by taking less care with her investments. As she can anticipate these effects, she reflects them in the price which she is willing to pay for insurance.

The insurance company wishes to make as much money out of Anne's business as possible. If it could convincingly promise to work hard in the wake of a loss, she would be prepared to pay more for her policy. Moreover, her incremental payment would be greater than the expected cost of keeping the promise. The problem is that both Anne and the insurance company know that this promise is not credible: once the contract has been signed the only incentive the company has to honour it is reputational. When its future business stream is in jeopardy this incentive is weakened and if it is hard to prove in the courts that the insurer is not honouring its word then the promise will be broken.

Note that a credible promise today would increase the insurance company's profits and would raise Anne's welfare. The company *wants to make the promise*, but it knows that it is incredible. In financial economics this is referred to as a time consistency problem. Time consistency problems arise when a principal wishes to make a commitment today in order to achieve better terms of trade, but will if possible renege upon this commitment in the future. Another example is of a lender who may wish commit today to punish default by withdrawing future funds and allowing the borrower to fail. Such a commitment would make the borrower work harder to repay its loan, but may not be credible. If the borrower is a corporation whose going-concern value exceeds its break-up value then it may anticipate refinancing; similarly, a quasi-governmental borrower (Railtrack, for example) may believe that its lender is unable for political reasons to let it fail. In either case the incentive effects of failure are reduced. Many of the failures of the socialist and transition economies have been attributed to time consistency problems (see Kronai,

[5] The special governance problems of the insurance industry have been advanced elsewhere as a rationale for the widespread adoption in the industry of the mutual form. See Birkmaier and Laster (1999) and Mayers and Smith (1988).

[6] The representative was Mick McAteer, quoted in *The Sunday Telegraph*, 10th December 2003.

Maskin and Roland, 2003, for a detailed discussion).

5. Regulation as Contract Enforcement

How could Anne and her insurer resolve their time consistency problem? Suppose that the insurer could find a trustworthy intermediary who would commit to enforce its promises. Such an intermediary would need legal powers to enforce the contractual promise made to Anne by her insurer because, as we have observed, the insurer would always prefer after the fact to renege upon its word. The intermediary's powers would render the promise credible: commitment problems in the market for insurance would be resolved and social welfare would be increased.

What type of promise could the insurance company make which would both satisfy Anne, and also be enforceable? One possibility would be to maintain a specific level of capital. An intermediary could check that capital reflected the level of risk inherent in the insurance policies and also in the assets which were held against them. When there was sufficient capital at stake the insurance company would be likely to work hard to maintain its position.

Of course, a promise to maintain substantial capital levels is not the only one which might satisfy Anne. The real point here relates to the role of the intermediary in enforcing a contract to which both Anne and the insurance company wish to sign up. Let us call this intermediary a "regulator". We can then think of regulation as *contract enforcement*. Regulation defined in these terms raises welfare by expanding the range of contracts available to the insurance company. Contracts could of course be predicated upon information generated by a commercial third party: the regulator's enforcement activities would then supplement those of the information producer, but would not necessarily supplant them.

Regulation defined as contract enforcement measures up quite well against the criteria introduced in the introduction. Firstly, time inconsistency is a well-defined problem which can be used as a yardstick against which to evaluate regulatory innovations. Secondly, regulation of this type works with the grain of the free market. Consumers in any market choose from several competing sets of promises. By expanding the range of available contracts, regulation-as-contract-enforcement actually *strengthens* the market mechanism.

Finally, a significant innovation of the contractual approach to regulation is its strict delineation of the regulator's role. When the regulator has a blanket responsibility for the safety and soundness of the financial system it is sometimes hard to say when a financial institution fails whether consumers could reasonably have expected the regulator to prevent whichever problem caused the failure. This uncertainty has several undesirable consequences. Firstly, if the managers of financial institutions expect to be able to pass off their failures as the regulators' then they may be more inclined to take dangerous gambles with their investors' funds. Secondly, if the regulators experience a high personal cost for failing to meet their obligations, a failure to define those obligations will naturally

lead to "regulatory creep": the scope of regulation will widen as regulators attempt to cover their backs. Thirdly, consumers who are unsure what they are buying may be less willing to invest in savings products. They may also abnegate their own responsibility to research and to monitor their investments. All three of these effects undermine the operation of the price system and will serve to diminish the effectiveness of the financial services industry.

In contrast, when the regulator's responsibility is limited on a case-by-case basis by the terms of the contract which it has signed with its client firm, it is clearer what it can and cannot be held responsible for. By extension, the responsibilities of the consumer and of the insurer are clearer. When consumers know precisely what they are paying for their decisions will be better and outcomes will be more efficient.

Of course, insurer promises to obey many existing regulations would be time-inconsistent and to this extent, existing regulations are consonant with the regulation-as-contract-enforcement paradigm. For example, the FSA has recently instituted a system of "realistic" capital requirements for insurance firms (FSA, 2004*b*). While their calculation is complex, the idea behind realistic capital requirements is simple: they should reflect more accurately than the previous figures complex risks relating to options and guaranteed returns. According to the FSA, the industry was clamouring for such regulation two years ago.[7] The rules are currently being implemented during a tough period for the insurance industry, and they are meeting with a good deal of resistance. This is entirely in line with the thesis outlined above: when they were well capitalised, insurance firms were eager to sign up to stringent capital requirements as these would facilitate contracting. The capital requirements were valuable *precisely because* the companies and their customers knew that without a legally-sanctioned enforcer capitalisation promises would be broken in a downturn. It is therefore natural that, during a downturn, the industry should lobby to see the rules relaxed.

Notwithstanding this inability of insurers to commit *ex ante* to solvency requirements, there is a gulf between the current regulatory landscape and the one which I propose here. I discuss two important differences below.

Firstly, an important feature of my ideas is that *the regulator should enforce only those promises which the insurer wishes to make.* The regulator's scrutiny should therefore be *optional*: insurance companies should design a set of promises and contract with the regulator to enforce them. Naturally, some promises (such as minimum capitalisation) would be easier to enforce than others: designing a regulatory contract would require some negotiation between the FSA and the insured. It seems likely that an unregulated company would fail to attract any customers, but such a company should under this approach be able to attempt to sell policies.

[7] In a speech at Cass Business School on 3rd March 2004, the FSA's Chief Executive John Tiner said that "12-18 months ago, the captains of the UK life industry were almost literally knocking my door down to introduce a solvency regime along the lines of the realistic approach, and to do it quick" (`http://www.fsa.gov.uk/pubs/speeches/sp167.html`).

The second distinguishing feature of the regulation-as-contract-enforcement idea concerns the regulator's monopoly position. While the extensive powers of the regulator may provide a good reason for a government to limit the number of regulatory licences which it issues, there is no *a priori* reason why the best number should be one. Furthermore, an overseas agency might be better placed to enforce certain types of contract: for example, one might expect a greater degree of expertise in regulating codetermination systems in Germany than in the U.K. This suggests that we should allow firms to opt for overseas regulation if they choose to. This is a strong argument in favour of mutual recognition of regulators, and against the harmonization of regulations.[8]

6. Conclusion

In this essay I have provided a rationale for a limited form of life insurance regulation. While regulation of some financial services, such as banking, is predicated upon externalities which have potential systemic consequences, these effects appear to be absent in the insurance industry, where consumers bear the costs of early exit and cannot trigger a destructive run. Insofar as a received wisdom exists, it appears to be that insurance company regulation is needed to protect consumers from the consequences of information asymmetries between insurance companies and their clients. But this argument appears to be flawed: if information asymmetry was the only problem then we could expect the market to generate disclosure, as it has in the bond markets. The informational problems in the life insurance markets are compounded by the illiquidity of life contracts: although this prevents destructive runs, it impedes the ability of the market to discipline poor performance or broken promises. It is therefore hard for life insurers to make credible long term commitments to their customers, even when there is sufficient information to identify problems. It is in this context that regulators have a role as contract enforcers: by expanding the menu of agreements into which the insurer can enter with its clients, regulation-as-contract-enforcement facilitates the free market and should increase welfare.

Of course, regulation along these lines would be a substantial sea-change. It would allow far more product differentiation between life insurance companies and might result in a proliferation of competing regulatory deals. A possible objection would be that consumers, faced with a bewildering array of complex alternatives, would make ill-informed and inappropriate choices. A similar case has been made by those who favour regulatory harmonization over diversity in the European Union.[9] This objection overlooks the success of bond rating agencies. A market institution could surely provide consumers with the summary statistics they would need to select their policies. Moreover, such an institution would, like the ratings agencies, account in its calculations for regulatory competence and so would serve as a further deterrent to regulatory capture.

[8] "Mutual recognition" occurs when the authorities in two countries each allow institutions regulated under the others' rules to operate in their own market. It forms the basis of the European Union's third life insurance directive. See Booth (2003).

[9] See Booth (2003) for a summary of this debate.

When regulators simply enforce contracts they have no particular role to play in selecting the contracts. Prescriptive regulation shrinks the range of available contracts and hence reduces welfare. So regulation should be *optional*, in the sense that insurance firms should be able to select their regulatory contract so as to give themselves a competitive edge. In the absence of systemic externalities, the only relevant measure of regulatory relevance is whether consumers are prepared to pay for it. It seems unlikely that a firm could succeed without subjecting itself to some level of regulatory oversight, but it should be allowed to try.

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