

European Master Program in Law and Economics

**Competition versus Regulation
In the Insurance Market:
A law and Economic Analysis of
Policy and Institutes**

Master thesis

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Authorship Declaration

I hereby declare and confirm that this thesis is entirely the result of my own work except where otherwise indicated. I gratefully acknowledge the supervision and guidance I have received from Prof. Thomas Eger.

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1. Introduction

The insurance business has become highly important to society's prosperity and development. Its solidity, as a financial market, is vital for the economy. Some say that the macro-economic effect of their collapse would be tremendous and that insurers are just "too big" to be allowed to fail. But due to certain characteristics, insurance markets' soundness is fragile, especially when judged by the general concept of assuring competition in the market.

The importance of the insurers' solvency to the economy and the un-balanced relationship between the insurers and the insured population, led legislators to heavily regulate this sector. This regulation includes licensing rules, ongoing supervision and intervention in the insurers-insured relations. Among other measures, the regulatory efforts rely upon the restriction of intra-industry competition.

The objective of limiting (potential-destructive) competition between insurers' is in conflicts with the broader approach of competition protection and encouragement. This conflict had been an important reason for a development of the de-regulation movement. But a crisis in the insurance industry brought this clash back into the focus of legal-economic debates.

The tension between the insurance regulation policy and the competition policy is the starting point of this research. Whether this tension is unavoidable or not, it clearly exists in many jurisdictions that choose to apply at the same time both competition policy of prohibiting trade restrictions and anticompetitive behavior, and insurance regulation.

This tension is dealt with in several ways that differ from one another, mainly in the extent that competition law is applied to insurance businesses; ranging from full application to full exemption. Yet, none of the resolving methods is perfect. This study analyzes the economic mechanisms in three jurisdictions, aiming to suggest the most efficient resolution that would maximize social welfare. The target of this attempt is a sustainable equilibrium between competition and the objectives of insurance regulation.

The above-mentioned tension exists not only on the fundamental level of the two branches, but also between the authorities in charge of them. This aspect is somehow absent from the discussions on the interrelations between competition and insurance regulation. But the authorities' tension is no less important, due to their crucial functions: first, the authorities are the mediators between the policy and its predicates,

the insurer as a regulated entity and as a competitor. A conflict between the two authorities imposes a threat of uncertainty and inconsistency. Second, the authorities have a great influence upon legislators, regarding the designing and changing of the policies they execute. Therefore, their mandate can roll-back to shape the "essential" tension, by moderating and resolving it, or by sharpening the conflict. This research tries to elaborate the institutions' role within the discussion. Based on economic analysis of the authorities' structures, it is suggested that a dual institutional model is superior. In light of certain economic weaknesses, the suggested model is accompanied by an operational method that would increase its efficiency.

This study researches only the primary insurance level; i.e., insurance companies and the competition amongst them. Neither does it examine the intermediate level between (insurance agents) nor the upper level of re-insurance. It should also be noted that insurance is examined here as a social-economic mechanism, without distinguishing between the insurance lines (life, non-life, casualty and property insurance), although there are significant differences between them. Furthermore, the research focuses only on commercial insurance (contrary to public social securities and insurance programs) for private consumers (contrary to the business insured).

The structure of this study starts with the basic questions: why does society need competition and insurance, why should these two branches be regulated, and why there is a tension between their regulations (Chapter 2). The research moves on to a survey of the development of the insurance and competition policies and authorities in three jurisdictions: the United States, the European Union and Israel, as a background for the core discussion – how do these three jurisdictions choose to resolve their policies and institutional tensions, and how successful are they in economic terms (Chapter 3). Later, the way in which these solutions are reflected in the courts, and used by insurers as defendants is described (Chapter 4). Lastly, a regulatory policy is suggested, containing competition considerations. Furthermore, the conclusion suggests an institutional model and operation method (Chapter 5). Several questions for further research will be proposed in the summary.

2. Policy Tensions

Economic policy is not an absolute value. Besides different economic regimes, incoherency can be found even within a single economic approach. Such disharmony exists between competition and insurance regulation.

2.1 Desirability of Competition and Justification for Its Regulation

The underscored supposition and justification of any competitive policy is that competition is a means for achieving economic efficiency. Perfectly competitive market equilibrium is Pareto efficient: no other market arrangement can make any agent better-off without making someone else worse-off.

There are few conditions for a market to be competitive [Areeda & Kaplow, 1988]: Numerous consumers and producers with no market power (all are price takers); No collusion between the agents; In the long run, the producers have free entry and exit to and from the market; Products are homogenous: consumers face no quality differences, thus base their decisions solely on price; Transaction costs are zero; Perfect information of producers and consumers.

The equilibrium point of the competitive market is defined by the intersection of the demand and supply curves. This point determines the quantity produced and purchased, and its price, which will be equal to the marginal cost of production. This equilibrium has two main effects: Firstly, no resources are wasted; all technical production skills are fully exhausted (therefore, only sufficiently efficient producers will survive the competition). Secondly, welfare maximization: all possible preferences are satisfied, and the total surplus (consumers' surplus: the value they attach to the product minus the price, *plus* producers' surplus: the price minus their production cost) is maximized.

The other extreme, contrary to perfect competition, is a monopoly: a single producer is able to control the price by limiting the quantity produced. Except for the unique situation of a natural monopoly (when the average cost is constantly declining, therefore a single producer would be more efficient than few), monopoly pricing leads to *inefficiency*: prices are charged above marginal cost and cause potentially efficient transactions to be eliminated, since some consumers are willing to pay a price that covers the marginal cost, but are not willing (or able) to pay the monopoly price. This is

a "*Dead-Weight Loss*", the welfare loss caused by monopoly. Besides that, productive resources are wasted in the attempt to gain a monopoly position (*Rent Seeking*). Additionally, monopolistic behavior has a *Distributional Effect*: surplus is redistributed on behalf of the monopoly. Although this is not a loss in welfare terms, the impairing of market fairness is often considered as an undesirable result of monopoly.

From Adam Smith's "invisible hand" concept, through classical economics, the Harvard school of behavioral economics approach and the Chicago school of pro-market approach; competition was always considered as desirable [Van den Bergh & Camesasca, 2001]. However, different approaches affect competition *policies*. Usually, competition protection is justified on the basis that in reality, the required conditions for perfect competition are not completely fulfilled. According to the Harvard school's approach, competition and market multi-structure are strongly linked. Therefore, collusion, market power and entry barriers should be rejected, unless circumstances for a natural monopoly exist. Other pro-competitive justifications were non-economic based, such as strengthening fairness or freedom [Sen, 1993] (by enabling freedom of choice). On the contrary, different approaches (such as Schumpeter's) saw monopolies as an inherent characteristic of economy dynamics and as a necessary condition for innovation. The Chicago school argued that efficiency is a single goal, thus rejected any non-economic arguments as well as any governmental interference against activities that aimed to maximize profits [Van den Bergh & Camesasca, 2001].

Competition regulations are aimed at protecting and maintaining competition, by prevention of collusion and market power abuse, [Viscusi et al., 2000] as well as by setting guidelines for commercial conduct and fair competition [Yagur, 2000].

2.2 The Functions of Insurance and the Objectives of Regulation

The earliest insurance type, marine insurance, was instituted in the 15th century. Later, other types appeared: fire insurance, life insurance, malfunction insurance etc. Since the last decades of the 19th century, insurance has become a popular product [Weller, 2005].

Insurance is an instrument for managing and coping with risk (the existence of a probability that a future loss will actually occur). Insurance replaces the uncertainty of loss occurrence at a lower cost [Posner, 1998].

2.2.1 Social Functions of Insurance: Economic and Non-Economic Goals

The practicality of insurance is based on three functions [Abraham, 2005]. Firstly, *Risk Transfer*: risk is transferred from the risk-averse individual (due to the diminishing marginal utility principle, people prefer to retain an assured value rather than an equivalent uncertain one, and are willing to pay a premium to eliminate what they consider as undesirable risk) [Weller, 2005] to the risk-neutral insurer (as long as the expected value remains equal, the insurer does not have any preference regarding it). Secondly, *Risk Pooling*: by insuring numerous policyholders, the individual's insured "uncertainty" is converted by insurer's "certainty", the predictability that such risk would occur to some of its customers. This is the essence of "The Rule of Large Numbers", the fundamental principle underlining insurance [Stigler, 1986]: the aggregated risk is smaller than the sum of the individual risks it covers. In order to enable risk-pooling, the risks should be quite homogenous (to prevent cross-subsidizing of the high-risk insured by low-risk insured) and independent (since losses of a common risk cannot be covered by payment of small individual premiums) [Weller, 2005]. Thirdly, *Risk Allocation*: the price each insured pays should reflect the risk he contributes. There is a trade-off between the cost of refining this classification and the benefit it creates by making the premiums proportional to the risks.

The overall outcome of the above-mentioned three economic functions implies that insurance is economically desirable. Entering into an insurance contract with no externalities enhances social welfare [Shavell, 1982; Shavell, 2000]; while in the same time, certain types of insurance induces taking cost-justified precautions, by internalizing damage. Furthermore, insurance encourages the risk-averse insured to make investments that they would hesitate to make otherwise, thereby enabling economic growth. Meanwhile, life insurance functions as a long-term investment and savings instrument [Weller, 2005]. This overview of the economic functions of insurance illustrates one of the definitions given to it: A "strategic buffer" for economy equilibrium [Van den Bergh, 1989].

Insurance also has non-economic social goals. Insurance changes the insured's norms and even influences their normative thinking. Firstly, since insurance companies have an incentive not only to diversify but also to *reduce risks*, they supply measures and by lobby for social efforts for risk prevention or minimization; e.g., insurance companies were the establishers the US fire-fighting forces and promoted public health programs such as immunizations. Secondly, insurance companies *influence and change*

private norms, by forcing people to take precautionary measures as an obligatory condition of an insurance contract. Thirdly, insurance *influences public debates*: insurance companies changed the religious-moral condemnation of life insurance as an intervention in God's will and as immoral quantification of life's value, into an opposite image, presenting the purchase of life insurance as a crucial moral obligation towards one's dependents [Weller, 2005]. Furthermore, insurance constitutes a *corrective measure (quasi-equalizer)*: it returns some wealth to the unlucky losers, thereby mitigating the dichotomy among society's members [Abraham, 2005]. Finally, some defined insurance as an *"educating" measure*: it strengthens public responsibility to reduce risks and contributes to the development of moral thinking by increasing social solidarity: the obligation to give (and the right to get) help in case of certain losses [Stone, 1999-2000].

2.2.2 Market Failures and Other Market Characteristics Underscoring Regulation

In order to discuss the pros and cons of insurance regulation and to analyze the tension it may create with competition regulation, it is necessary to discuss the features that differentiate the insurance market from other markets, and the reasoning they comprise for regulating this market.

The insurance industry is characterized by the fundamental problem of *Dual Asymmetric Information*: the insured have great difficulties in understanding complicated insurance contracts and lacks the ability to assess the adequacy and proportionality of the premium to their risk. This aspect of the asymmetry is "Lack of Transparency" [Wulf-Henning, 2000]. Insurance products may be defined as "Experience good" or "Credence good", since the insured can evaluate their quality only after concluding the contract, if at all. In the same time, insurers suffer from lack of information regarding the risk posed by a given insured individual. That aspect of the asymmetry leads to two highly discussed phenomenon: *Adverse Selection* and *Moral Hazard*.

Adverse selection [Akerlof, 1970]: high-risk parties, who have a greater incentive to be insured, pay relatively low premiums (due to inability of the insurer to assess the actual risk they pose). Therefore, the number of claimants and amount of losses increase. As a result, insurance premiums increase, which in turn causes low-risk parties to avoid purchasing insurance. This chain of events leads to the remaining of only high-risks under insurance coverage. The possible long-run consequence of

eliminating the "good" insurance segments is a collapse of the entire market. Other factors for the occurrence of adverse selection are heterogeneity of loss probability among the insured, risk aversion of the low-risk parties (which determines the elasticity of demand) and the level of awareness the insured regarding the risk they pose [Weller, 2005].

Moral hazard: The insured's activity behavior changes after purchasing an insurance policy [Shavell, 1979]. They are prone to reduce their risk-reducing efforts. This leads to higher risks and higher insurance costs [Posner, 1998]. The setting for moral hazard development is the change in the insured's behavior, and the inability of the insurer to either predict this change in advance or to prevent it by exempting such behavior from the insurance contract's coverage [Weller, 2005].

The above-mentioned phenomena can be regarded as two of the classic market failures: asymmetric information and externalities (the moral hazard risk increase is a negative externality, though it should be mentioned that the social functions of insurance can be interpreted as positive externalities; compulsory insurance is sometimes based on this perception) [Van den Bergh, 1989]. These market failures are cited as a justification for regulation.

But the main reasoning for insurance regulation is another fundamental characteristic of the insurance market: the need for high financial stability, due to the "long-tail" nature of the insurance product and the fact it is trust-based. *Long-tail* character means that at the stage of purchasing the insurance, the consumer receives a mere promise. Therefore, insurers' solvency requires more assurance than the solvency of other commercial entities, since the value of a promise-product depends totally on the ability to keep it [Abraham, 2005; Meier, 1988]. *Trust* is a crucial element for the insured's willingness to put their savings in the insurers' custody, or to rely on their services for future planning [Wulf-Henning, 2000].

Macro-level analysis also supports insurance regulation and solvency protection: Insurers hold enormous amounts of funds and investments; as such, their failure would have extreme influence on many policyholders and beneficiaries (mainly in life insurance, where there would be no possibility of finding an alternative to loss of life-long savings) [Ellis, 1990]. The stability of the insurance industry, as other financial markets, is a crucial element for general economic equilibrium. Another threat is posed by some structural elements of the insurance market, known as the capacity argument

[Wulf-Henning, 2000] or the destructive competition argument [Van den Bergh, 1989]. Insurance production has no tangible limits: except for higher administration costs, insurance capacity is quite unlimited, as is the market access (unless regulatory barriers to entry are created). Therefore, excessive capacity might occur. Together with the long-tail characteristic, such circumstances might lead to destructive competition: insurers may be induced to charge dumping prices that eventually would not cover the claimants (due to the "long-tail", a long time would pass until this would be discovered). Obviously, such a race to the bottom jeopardizes the solvency of insurers. This scenario is a sound argument for regulating the insurance industry.

Three functional economic features concerned with special needs for cooperation and are cited as regulatory justification (or, more accurately, as a reason for a special application of the competition policy): Firstly, the need to cooperate for enabling proper assessment of risk and the accurate setting of rates. The success of the insurance industry depends highly on the scope of the database it relies on; the "Rule of Large Numbers" requires a wide statistic base for risk assessment, risk classification and setting adequate premiums. A possible interpretation of such a database is that it is actually a natural monopoly (since it involves substantial economies of scale). Thereby, it falls into the most agreed-upon justification for regulation. But even if a formal common database is not established, in order to avoid inefficiency and to prevent erroneous rate setting, insurers need information cooperation. Secondly, cooperation is needed for enabling re-insurance: re-insurers force insurers to use quite similar definitions and classifications, because "tailored" re-insurance for each insurer separately, would be too costly to produce. Thirdly, cooperation for co-insurance: some risks are too large to be insured by a single insurer. Therefore, cooperation between insurers is the only way they can be covered.

The above-mentioned market characteristics and reasons for regulation are translated into two general regulatory goals: Industry protection and consumer protection.

The former basically arises from the economic functions of insurance and the above-mentioned justifications. The essence of this protection is the assurance of solvency and the stability of insurance companies and the insurance market as a whole.

The consumer protection goal is strongly linked to the first, but has some additional reasoning. The core of this approach is that the insured are relatively weak

compared to the insurers: they face standard but complicated contracts (causing a lack of transparency); they have difficulty in assessing the objective risk and they are exposed to inadequate risk classification by the generalizations that insurers make. For consumers to be protected, solvency regulation is not enough: insurance companies may charge not only dumping prices, they also exaggerated prices (especially if competition is limited) by abusing these consumers' relative disadvantages. Therefore, consumer protection is a declared objective of insurance regulatory authorities [Weller, 2005]; trying to achieve a corrective balance in the insurance market.

Common definitions of regulation objectives in the legal-regulatory literature are "fairness" "access assurance" [Meier, 1988, p. 47]:

"Insurance should be available to all individuals that need or are required to have it... access means access at a reasonable price".

Part of this approach is an inherent tendency to resolve conflicts on behalf of the consumer. This tendency is (potentially) economically efficient, since it is weighted by the insurers and premium calculations are adjusted accordingly [Posner, 1998].

2.2.3 Main Types of Insurance Regulations

The justifications and goals mentioned in the previous section led the legislators to establish three main types of insurance regulations: Solvency, Rate and Policy Regulation. After a brief survey, these types will challenge by competition-oriented criticism.

2.2.3.1 Solvency Regulation

Three methods are applied under this regulation [Macey & Miller, 1993]. Firstly, *Technical Reserve Requirements* and *Licensing Conditions*: minimum capital requirements, limitations on corporate structure and ownership, and sometimes a ban on engagement in any other business except insurance and related investments [Ellis, 1990]. These are aimed to assure the financial stability of potential insurance companies and the sufficiency of their initial financial resources to cover the underwriting liabilities. Such supervision makes the insurance regulatory authorities highly involved in shaping the market structure, since they exert great influence by approving the insurance suppliers before they enter the market.

Secondly, *Regulatory Safety and Soundness Supervision*: insurers' assets should actually be larger than the underwriting liabilities by including "a margin of solvency" [Ellis, 1990]. Under threat of receivership and liquidation according to the Insurance

Commissioner's (hereinafter: IC) decision, this form of regulation relies on the regulators' examination of annual financial statements made by the insurance companies; supervision of companies' investments; intensive investigation and solvency improvement requirements [Macey & Miller, 1993].

Thirdly, an instrument of solvency regulation is the *Guaranty Funds*. In case of liquidation or insolvency, these funds are supposed to protect policyholders, beneficiaries and claimants to a greater degree than the protection granted to creditors by "normal" bankruptcy rules. The funds, often financed by the remaining companies according to assessment of their market-share [Abraham, 2005], cover the payment that should be made to a failing insurer's policyholders.

2.2.3.2 Rate Regulation

Rate regulation is based on three essentials: the consumers' bargaining disadvantage; information asymmetry that put the consumer in a relatively weaker position [Macey & Miller, 1993] and the race to the threat of "race to the bottom" (although the later is mostly addressed by solvency regulation) [Widiss, 1989, p.890]:

"The regulation of premium rates is generally intended to assure that an insurer's income is adequate to cover risks (with a reasonable margin) without being either excessively expensive for the purchaser or unfairly discriminatory among purchasers".

There are few rate-setting forms: **Administrated Prices**: full regulatory prescription of rates, a rare but yet existing method; **Prior Approval**: the IC approves insurance rates files proposed by the insurers, the most common form of rate regulation; **"File and Use"**: rates can be changed unilaterally by the insurers but the IC may reject them at a later stage; **Flex Rating**: insurers are free to change rates within a range set by the regulator; and finally **Open Competition Rate Setting**: a minimal governmental intervention with a mere residual regulatory authority, granting the IC only a veto power to reject rates if they are found as "unfair, unreasonable or excessive" [Macey & Miller, 1993; Abraham, 2005].

2.2.3.3 Policy Regulation

Policy regulation is mostly consumer-protection oriented [Weller, 2005]: to resolve the balance problem (the consumer's disadvantages) without harming the efficiency rising from transaction costs reduction by standard contracts, insurance policies are also monitored. This regulation is based on requiring the inclusion of mandatory provisions and the prior approval of insurance contracts and their continuous

changes by the regulators. Although the distributional effect of these provisions is doubtful, since insurers make all the efforts to weight them and include their value in their rates and premiums, the inclusion of these provisions prevents, or at least mitigates, the problem of elimination of insurance segments due to adverse selection, especially if it is accompanied by rate regulation. It also protects the consumers from the effects of cognitive dissonances (over-optimism, influence of recent events, presentation style, and underestimating future benefits, such as pensions).

2.3 The Tension: Weighing-Up Competition against Regulation

The justifications for regulating the insurance market are often highly criticized from a competitive point of view. Others argue that the regulation forms are not only necessary for efficiency but might even enhance competition. What is the impact that regulation has on competition and on the insurance market's efficiency?

2.3.1 Rate Regulation from a Competitive Perspective

The first and foremost criticism is made, naturally, against vigorous rate regulation, since it is widely considered as the most intrusive interference in the market and the pricing mechanism. Although there is a range of regulatory control forms, all (except "open competition") grant the regulator the power to set prices, with or without the influence of market agents.

The greatest threat rate regulation poses to competitive pricing and market efficiency, is that the regulator would set or approve *faulty* prices and thereby lead to distortions and inefficiencies. Even if high administrative costs would be invested, regulators would always be in inferior position: their knowledge is based on information supplied through the insurers' "filter" (while the insurers themselves do not have perfect information). Therefore, inadequate price setting is very likely, especially if the regulator attempts to regulate not only the pure premium rates, but also other price-elements [Van den Breghe, 1989]. Empirically, regulators usually set rates above the competitive price e.g., in the 1980's, the highly regulated Belgium life insurance premiums were triple the British market prices.

Distortion occurs either when the price is set too high, or too low, compared to a competitive price. Both types are inefficient [Macey & Miller, 1993].

In the case where prices are set too high, no insurer would leave the market, but the normal dynamics of price mechanism (new firms entering the market and leading to

price reduction) would be, at the very least, delayed, because of the regulatory entry barriers. While insurers would earn abnormal profits, some consumers would leave the market due to the excessive pricing. Thereby, insurers would have no (or: low) incentive to improve their efficiency. The insurers' tendency to engage in non-price competition [Van Den Bergh, 1989], would increase the inefficiency even more so, since resources will be used to finance non-productive expenses.

In the case where prices are set too low, and as long as the exit from the market is free, insurers would simply withdraw from the market (or become insolvent). True, such movement will be firstly done by the less efficient insurers who would not be able to operate under these conditions. Besides that, a protest by consumers left with no insurance coverage may influence the regulator to raise prices closer to a competitive level. Still, three problems remain: Firstly, in case there are insufficient guaranties, the withdrawal by insurers exposes their policyholders and beneficiaries to the danger of no insurance coverage. Secondly, until rate setting will be corrected, there would be supply shortage. Finally, the later regulatory rates correction would not be necessarily adequate: it may still be too low or go to the other extreme of a too-high rate setting.

Insurance regulator not only suffers from an information disadvantage, he is also highly influenced by different incentives, and does not neutrally represent the public's interest [Van Den Bergh, 1989]. Except for the distorting self-interest of the bureaucrats themselves, the regulators are subject to great pressures by both consumers' and insurers' interest groups. After the worldwide deregulation movement during the 1970's, consumers now tend to seek rate regulation in order to achieve a rate rollback. By that, they ignore past experience: insurers used regulators to enforce rates set by industrial rate bureaus, which actually operated as very efficient cartels [Macey & Miller, 1993]. From a public choice theory perspective, the regulators are "captured" by the industry that enlists them to serve its members' interests [Van den Bergh, 1989]. Currently, a new approach is becoming more prevalent in the US: combining regulatory low rate-setting with "exit fees", imposed on insurers wishing to withdraw from the market. These fees are supposed to convince insurers to stay in the market even after a compulsory rate reduction. This approach, although intended to protect consumers' interests, is even more harmful than mere rate-setting. The "hold-up" position undermines the ability of insurers to remain solvent, and therefore, in the long run, it would be harmful for consumers as well [Macey & Miller, 1993].

To close the discussion about rate-regulation influences upon competition, a comment regarding market structure should be made. The interrelations between the two apparent extremes are not so dichotomous. The repeal of rate regulation would not necessarily lead to perfect competitive pricing if the market structure itself is not perfectly competitive [Abraham, 2005, p. 117]:

"In a setting where there is imperfect competition... and imperfect information in the Commissioner's office... the ultimate issue in rate regulation is where to vest the authority to make a mistake".

Although insurance market tends to non-price competition, rate regulation might still lead to reduction, even elimination, of price competition [Ellis, 1990] and thereby create an oligopoly or oligopoly-style pricing (i.e. pricing higher than under a competitive structure, based on un-forbidden coordination, due to recognition of the interdependence between the few competitors [Baker, 1993]), as it strengthens self-regulation tendencies and even serves as an enforcement measure for them [van den Bergh, 1989].

On the other hand, as long as the market structure is competitive enough, the possible negative effect of distortion are somehow mitigated by reality limitation of administration budgets. Since the regulators usually do not receive an adequate share of the governmental budget for assessing rates as correctly as possible, they usually rely on the proposed tariffs made by the insurers. They manage consider the reasonableness of this tariff by checking insurers' financial reports. The more competitive the market is, the more adequate the tariff. Even if rates are approved or even set by the regulator, the competition might still be transferred to the proposal stage. That increases the desirability of the regulatory rate setting [Widiss, 1989].

2.3.2 The Effect of Cooperation Allowances on Competition

This section analyzes the (ambiguous) impact that the above-mentioned cooperation needs have upon competition. The core of this debate is weighing-up the benefit of multiple market structure of numerous insurers (each with small market-share) against the "costs" of the *facilitating practices* arising from the cooperation such a structure requires (the threat that these cooperative practices enables rivals to engage in anticompetitive behavior, whether by manifested agreement, which is a clear violation of competition law, or by mutual understanding coordination, which is nearly impossible to forbid). Truly, one of the necessary conditions for a competitive market is complete information. But this does not imply that the information should be given by

competitors. Just the opposite: it should be based on market dynamics, without interrelations between the rivals. As Adam Smith argued very accurately [1937, p. 127-128]:

"People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices... But though the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such practices..."

It is important to note that the facilitating practices can grow on two different platforms related to regulation. Firstly, on the allowance of cooperation (exempting the insurance market from the normal application of competition policy is a sort of regulation); Secondly, the relations between each insurer and the insurance regulator may establish insurers' cooperation, declared or hidden, deliberate or consequential.

2.3.2.1 Cooperation of Information and Rate Calculations

Insurance tariff bureaus process few elements of information into a general advisory rate: 1) historical loss data, 2) trend analysis (of law changes, inflation rates and prediction of future policy losses for past policies), 3) evaluation of operating expenses, 4) assessment of anticipated litigation costs, 5) the profit which an insurer should expect from charging the advisory tariff. Macey & Miller [1993] see no justification to allow any information sharing except historical loss data and, to some extent, trends analysis, regarding only future policy losses of past policies. They argue that all other information exchanges are nothing but facilitating practices: they are not related to any particular characteristics of the insurance market, therefore there is no difference between recommendation of complete rate calculation and price fixing, even if it is declared as "advisory" and not as an intra-industry compulsory rate-setting. This approach is similar to the limits of the European Regulation (see chapter 3) allowing cooperation for premium calculation [Wulf-Henning, 2000].

True, the "Rule of Large Numbers" requires some cooperation in the insurance industry, e.g. establishment of common databases. Indeed, such databases enable small insurers to operate. But the contribution they raise for market efficiency is not obvious. Mere loss data information might be sufficient, on the one hand, to enable the operation of small firms and to push inefficient firms out of the market, on the other hand; Illinois's insurance market, based on competitive pricing, proves that [Macey & Miller, 1993].

Another proof for the necessity of competition in premium calculation activity is the effort and costs invested by insurers in risk classification. Unless the calculation "market" was subjected to some competition, insurers would prefer to save these costs and to use pooling to cope with potential adverse selection. But the intra-industry Nash Equilibrium induces firms to classify risks and to create detailed premium ranges for different risk-groups: each insurer knows that other insurers will attempt to offer some low-price premiums to the less risky insured and capture this profitable market segment. Indeed, a common database is beneficial for the market as a whole, but it would be inefficient if no (competitive) incentive remains to make the best of it.

2.3.2.2 Cooperation of Policy Standardization

Cooperation supporters argue that standardized-oriented cooperation enables comparability, and makes it easier for the consumer to make a rational choice between different insurers. The reasoning is similar to the basic justification for policy regulation: insured information disadvantage and their inability to fully understand the insurance contract. At the same time, cooperation does not eliminate competition between insurers, but rather directs it to other market levels, such as service and administration [Van den Bergh, 1989].

But standardization cooperation is not unequivocally desirable. It is quite obvious that frequent meetings of competitive insurers, to discuss their products and services, may facilitate anticompetitive behavior within the insurance market. Some argue that the difficulties understanding insurance contracts are not the main reason for the irrational choice of an insurance policy by consumers. Consumers are affected by risk aversion on the one hand and over-optimism on the other hand. They are biased by the way policies are presented to them and by the insurance agents' recommendations, which do not necessarily parallel to the consumers' interest. Therefore, standardized comparability would not necessarily lead to a positive outcome of rational choice, while the negative effects of "facilitating practices" still remains.

Other possible damages of standardization cooperation are stagnation and fossilization. Insurers would be reluctant about innovation due to the free ride threat, knowing that at periodic meetings, new insurance products would be published to all competitors and may be standardized. This leads to stagnation and to a potential elimination of the market segment of "tailor made" insurance; making the market less responsive to clients' needs [Van den Bergh, 1989].

2.3.3 Solvency Regulation from a Competitive Perspective

It is unanimously agreed that solvency regulation is needed for the insurance market's operations. All three jurisdictions examined in this research impose these requirements. Even from a competitive perspective, no rejection is made. Although solvency requirements, mainly in the licensing stage, are a barrier to entry, and leave the less solid candidates out of the insurers' group, this is not considered as harming the competition. It protects the public interest as a whole, including the existing insurers, from the danger of opportunistic short-run insurers, who would dump prices, capture immediate gain and leave the market soon afterwards. My personal interpretation is that this unanimous consent is based on the perception, that solvency is an inherent condition of the market's definition: insolvent candidates are simply irrelevant, and can not even be considered as potential competitors so their entrance has been restricted.

2.4 Concluding Remarks

This chapter presented the desirability of competition and insurance, and described, on the basis of economic-structural characteristics, the objectives of insurance regulation. The justifications underscoring insurance regulation were counterbalanced by the harm it might cause to competition and, as a result, to market efficiency.

This review leads to two main conclusions. First, I find that there is a fundamental theoretical incompatibility between the efficiency-oriented competition and the nature of insurance markets, including its market failures and unique characteristics. The general aims of efficiency and social welfare may be common to both competition policy and (extensive) insurance regulation,¹ but the conflict between them is inherent.

The second conclusion is perhaps the practical aspect of the first and the basis for the rest of the discussion of this research. Since the contradiction is inherent, it should not matter, in the practical perspective, if the justifications for insurance regulation and the effect it has on competition is justified and desirable, or not. The only issue that matters is that society wishes to have them both – competition *and* insurance regulation. Therefore, the aim should be to find the way to cope with this tension, not to neutralize it essentially.

¹ Although each also has other goals, not necessarily contradictory or economical.

3. The Way the Tension Is Dealt With by Law: Comparative Observation of Policies, Exemptions and Authorities

Acknowledging that the possible contradiction that exists between competition policy and insurance regulation, legislators try to find a way to combine them in the public sphere. This chapter presents the manner this tension is dealt with in three jurisdictions.

3.1 Development of Competition Policy and Insurance Regulation

3.1.1 The European Union

Differently from other jurisdictions where competition policy is aimed only at maximizing economic efficiency, in the EU it has another important goal: facilitating a common integrated market, a primary objective of the EU. With this background, competition policy gained a quasi-constitutional status, which affects the relationship between competition and regulation [OECD, 2005].

Competition policy guidelines are defined in the Treaty, and further expanded by the European Council and Parliament, as well as by Member States in the state-level. The policy is enforced by the European Commission as a Union-level competition authority, the decisions by the Court of First Instance and the European High Court of Justice (ECJ) and by Member States competition authorities and courts. EU authorities enforce the Community policy, while national authorities may apply both Community policy and national competition laws.

Article 81(1) of the Treaty prohibits

"...all agreements between undertakings... and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market...".

In particular, price-fixing or trading conditions are prohibited. Article 81(2) voids such agreements and practices. Article 81(3), as a general exemption, mitigates the voidance: agreements may be allowed if they are necessary to improve production, distribution, technical or economic progress; as long as they allow consumers a fair share of the benefit and only in so far as they do not eliminate competition in respect of a substantial part of the products in question.

Insurance regulation in the EU also has a community goal aside from the "normal" regulation justifications: the creation of a single European insurance market

[Wulf-Henning, 2002]. Yet, harmonization efforts have continued for 30 years and are not yet completed. The difficulties of establishing a Union-level insurance regulation arises from the contradictions between two substantial regulatory schemes: some states, among them, Germany and France, had a tradition of intensive state supervision, entitled "the Alpine regulation", while the United Kingdom and The Netherlands had "the maritime insurance": a well-founded tradition of a self-regulated insurance market, almost completely free of state intervention.

The evolvement of Union-level insurance regulation included three stages. The *First Generation* was the adoption of directives that were aimed at facilitating the freedom of establishment for non-life (property and casualty) insurance in 1973 [Directive 73/239/EEC: (1973) OJEC L 228/3] and for life insurance in 1979 [Directive 79/267/EEC: (1979) OJEC L 63/1]. The *Second Generation* was the legislation of two directives, in 1988 for non-life insurance [Directive 88/357/EEC: (1988) OJEC L 172/1.], and in 1990 for life insurance [Directive 90/619/EEC: (1990) OJEC L 330/50]. Their core was the abolishment of prior approval of terms and premiums. The *Third Generation* was the installation of a single market regulatory system in the "Europe 1992" directives: Non-life insurance [Directive 92/49/EEC: (1992) OJEC L 228/1 (hereinafter: non-life directive)] as well as life insurance [Directive 92/96/EEC: (1992) OJEC L 360/1 (hereinafter: life directive)].

From state regulation to a single insurance market: prior to opening the insurance market by the second and third directives, it was mostly national (except for re-insurance and co-insurance), due to national regulations. Therefore, concerning competition, the cooperation between insurers was also on a local level and did not have a substantial effect on interstate trade [Wulf-Henning, 2000] (although the aspect of "competition within the common market" is interpreted very broadly by the ECJ). Some argue that the restriction of national regulation and the opening of the market to interstate competition simply transferred regulation to the insurers themselves. Others see the European exemptions' (see section 3.2) as a substantive guidance, and claim that the cooperation they allow simply replaces the need to base standardization on regulation [Wulf-Henning, 2000].

Regarding interstate trade, the basic choice the EU faced was between subjecting the insurers to the control of their home state (*home*) or the host state (*host*). The *Host* regulations' clear advantage is that the consumers are not distorted by the

implications of regulatory differences [Wulf-Henning, 2002]. On the other hand, the *host* regulation approach forces multi-state providers to comply with many different requirements, which results in inefficiency and the insurers' reluctance to operate inter-state.

Yet, *home* regulation might result in regulatory competition: in order to attract foreign investors to establish their insurance business in their territory, Member States (MS) might enact minimal, even insufficient regulatory requirements, which would eventually harm the industry and the policyholders. But this short-term thinking is not proven in reality. Empirical evidence implies that no "regulatory-arbitrage-gain consideration" evolved in the insurers' decision-making process [Wulf-Henning, 2002].

On this ground, the Third Generation Directives made a dramatic change: shifting to *home* regulation (accept the regulation concerning business behavior) [Wulf-Henning, 2002]. This move has three pillars:

Single licensing system and home control on ongoing businesses: any state authorizing an insurer to operate abroad issues a "European License", which must be accepted as sufficient by the *host* [§5 Non-life directive; §4 Life directive]. At the same time, *home* must supervise the insurer's financial stability and administrative structure before granting such authorization. Also, a notification about the business expansion into the *host* state must be given by the *home* authorities [§§32, 34-35 Non-life directive; §§32, 34-35 Life directive]. A parallel principle is applied regarding ongoing businesses: insurers are subject to their *home* regulation, while *home* is obliged to supervise their solvency. Three of the European basic freedoms (establishment, providing service and capital) are efficiently facilitated by this uniform system, while *host* interests are still protected by three means: regulation by *home*, close cooperation between the regulators and by *host* residual regulatory competence for emergency situations.

The two other pillars are derived from the first one: some degree of *harmonization* is a prerequisite for enabling *home* regulation. Therefore, the third directives include requirements regarding solvency (minimal capital, solvency ratio etc.), adequate management, etc. Lastly, *Mutual recognition*: ever since the directives came into force (in 1994), any MS must accept, as a *host*, any establishment of a branch or other form of insurance service provider, registered in another member state, even if

its own requirements for the establishment of insurance business are stricter than those of the insurers' *home* state.

3.1.2 United States

In 1890, the "Sherman Act" [26 Stat. 209, 15 U.S.C.A] was passed to prevent giant economic organizations from controlling the market by mutual agreements and to prevent monopoly abuse. Later the "Clayton Act" and the "Federal Trade Commission Act" were added. Sherman Act prohibits agreements that restrict competition as a goal or in fact and the abuse of monopoly power. Violation of these provisions is a criminal offence. The Articles were phrased very broadly, enabling a wide range for court interpretation.

Although there are also state antitrust laws, anticompetitive behavior is mostly dealt with by the Sherman Act. It is enforced by four means: The broadest supervision is by the Federal Trade Commission (FTC) that can declare a practice as anticompetitive and therefore illegal. Other enforcement branches are the Department of Justice (DOJ), the State Attorney General and private suits. The antitrust law is intensively shaped and enforced by the Supreme Court (SC).

Similar to the EU, the US insurance regulation is based explicitly upon state regulation. The regulation flourished in the early decades of the last century, went through a deregulation process during the 1970's, and recuperated, not without debate, after a crisis occurred in the insurance market in the 1980's. Yet, there is no federal insurance regulation; very few federal acts that may indirectly affect insurance businesses.

State-National Debate: Just as the EU, the US faced the same dilemma, between state and national insurance regulation, but the US chose the other direction, and allocated the regulatory power to the states, by exempting state-regulated insurance businesses from the (federal) antitrust law.

Unlike the EU single market approach, an insurer in the US is subject to the regulation of each and every state it operates in [OECD, 1998]. These variations obviously increase insurers' transaction costs, compared to a uniform federal system. On the other hand, state regulation can be "tailored" better, according to local risks and needs [OECD, 1998; Lemaire & Subramanian, 1997].

The origin of allocating regulatory powers to the states did not result from essential priority in regulating insurance, but rather from the *federalist scheme* of granting powers to the states unless an activity is "interstate commerce" [OECD, 1998]. Initially, insurance businesses were not considered as such. This assumption cannot stand any longer. The question arises, then, if regulation should remain a state power, or should it shift to federal one.

The core of the US state-federal debate relates exactly to the tension between competition principles and insurance characteristics. The regulations at stake are Rate Regulation and Solvency Regulation.

Different Rate Regulations are the essence of the divergence of the states' approach regarding competition in the insurance market. California and Illinois can demonstrate the two extremes. In California, direct vote led to the enactment of "Proposition 103" [Cal. Ins. Code §1861.01] (1987), which heavily intervened in insurance rates: all premiums were reduced by 20%; a prior approval procedure was established and in some insurance lines, the state sets the rate. This may be considered as a clear declaration that competition in the insurance market is not reliable. In contrast, since 1971, Illinois permits nearly fully competitive rate setting with minimal state oversight for most insurance lines. The empirical evidence, that no substantial crisis occurred in Illinois's free-market and that its automobile premiums are relatively low, led some to assess that no rate regulation is required: the characteristics of numerous providers and a homogenous product are enough to set rates fairly and correctly [Macey & Miller, 1993].

Solvency Regulation, on the contrary, is treated differently. Even state-regulation supporters agree that a certain level of harmonization or standardization is required, especially since many insurers are operating on a multi-state level. Macey & Miller [1993] argue that there should be no federal solvency regulation since the insurance industry is stable, but find some degree of federal intervention to coordinate state solvency regulation as desirable.

3.1.3 Israel

Until two decades ago, the Israeli antitrust law, which was based on common law, was very moderate and rarely applied. The current law, Restrictive Trade Practices Act, 1988 (RTPA), created a completely new sphere of competition protection. It is enforced by the Israeli Antitrust Authority (IAA, headed by a General Director (GD))

with the powers of supervising, investigating, initiating civil and criminal proceedings, ordering monopolies and approving/disapproving mergers. But the "Big Bang" of the new antitrust policy relates to the insurance market: the first broad investigation of a cartel, which led to the broadest court analysis of the Trade Restriction criminal offence, considered the insurance companies a cartel (see chapter 4).

Israeli insurance regulation is considered as "consumer protection" oriented, although this goal is evenly divided into two [The Israel Democracy Institute, 2006]: direct protection, through supervising the policies insurers' practices, *and* indirect protection, though preserving the stability of the insurance companies. In the light of the increasing weight given to competition in the financial services, the "Insurance Supervision Act, 1981" was recently amended (by the "Increase of Competition and Decrease of Concentration and Conflict of Interests in the Israeli Capital Market Act, 2005", hereinafter: Increasing Competition Act), and it is now called the "Control of Financial Services (Insurance) 1981 Law". The IC has the power to apply stringent regulations including authority for: licensing; ongoing supervision that includes approval rates procedures (for some insurance lines), policies and underwriting changes; issuing obligatory orders and appointing managers in case of a management failure.

Israel as a Small Economy: Israel is a "small economy". As such, it is characterized by high industrial concentration that might adversely affect efficiency, especially in markets requiring economies of scale, such as the insurance market. The tension between regulation and competition protection is extended in small economies: an oligopoly structure arises naturally and therefore should be tolerated. But at the same time, the need for scrutiny of the competition is greater than in large economies, since the market structure is not multifaceted enough to establish healthy competition and may ease the establishment and self-enforcement of cartels [Gal, 2003].

Unlike the US and EU insurance markets, the Israeli insurance market is very concentrated. It contains 38 companies, formed into 13 groups. In 2003, the two largest groups' market share was 48%, and the market share of the five largest was 84% [The Israel Democracy Institute, 2004]. It should be noted that in recent years there was some increase in competitiveness due to the entrance of foreign insurers and due to structural changes in the banking system. Yet, in general, the industry is still very concentrated.

3.1.4 International Level (IAIS)

Although differences do exist, insurance regulators face similar problems that exist on a worldwide level. This fact, and the increasing tendency of insurance services to expansion across-borders, led to the establishment of an international organization. The International Association of Insurance Supervisors (IAIS) was established in 1994, in order to enable information-sharing between insurance supervisors and regulators. Soon after, broader needs were found, and the organization objectives expanded accordingly. Today, the IAIS goals are as follows [OECD, 1998, p. 225]:

- a) Cooperate to ensure...supervision...in order to maintain efficient, safe, stable insurance markets for the benefit and protection of policyholders;
- b) To unite efforts to develop practical standards for supervision;
- c) To cooperate with other relevant entities, especially with Basle Committee on Banking Supervision and the International Organization of Securities Commissions;
- d) To provide mutual assistance to safeguard integrity.

IAIS developed several principles that ought to serve as a common base and guide for its 180 member jurisdictions [IAIS web-site]. The Insurance Core Principles (ICP) were updated in 2000, and today include 17 principles that the members are supposed to apply in their supervision. The aim is to achieve consistent regulation rules that would prevent the phenomena of regulation arbitrage. Among the principles, supervisors are mostly called to maintain stability in their regulated markets, to gain the needed power to review the insurers' assets, reserves, internal control etc., and the power to "take remedial actions" [Capital Markets, Insurance and Savings Division, 2004].

Yet, although the consistency of regulatory policies is very important and useful, and indeed have the potential to prevent, or at least to reduce the risk of regulation arbitrage, IAIS does not affect the interrelations between insurance regulation and competition. It does not imply that insurance supervision should include competition considerations, nor does it mention coordination with competition authorities amongst its goals. Therefore, it does not actually contribute to the resolution of the tension between insurance regulation and competition. But, in case these goals or synergies should be adopted, the IAIS has an important potential function of spreading this concept among its members.

3.2 Resolving the Tension? Competition Policy Application

3.2.1 EU: Partial Exemption

The main *prima facie* anticompetitive practices the Commission faces in the insurance market are agreements between insurers [OECD, 1998]. Therefore, the most relevant Treaty Article is 81(1). But until the mid 1980's, it was unclear whether the insurance market is subject to the European competition policy: analogous to the special treatment granted to agriculture and transportation, and relying on some national regulations that partially exempted the insurance industry from the application of the competition policy, insurers argued that the insurance market, due to its special characteristics, should not be subjected to the competition rules [Reich, 2001].

After implying so in the *Nuovo* decision [*Nuovo Cegam* O.J. 1984 L 99/29], Commission clearly stated that insurance industry *is* subjected to the competition law, in the case of *Verband der Sachversicherer* [O.J. 1985 L 35/20]. In this case, the insurers union recommended to its members to increase certain premiums, in order to stabilize market segment; a recommendation that was indirectly enforced by re-insurers. Although the national insurance regulator and competition authority approved this agreement, the Commission found it to be a trade restriction, since the cooperation between the undertakings was greater than necessary or justified. By upholding this decision on the appeal judgment [45/85 *Verband der Sachversicherer v. Commission* [1987] E.C.R. 405], the ECJ brought any remaining doubts to an end: insurance companies were subjected to the competition policy.

This decision led to an immediate response. Attempting to overcome the judgment's consequences and to maintain the validity of their cooperation agreements, insurers applied for numerous individual exemptions that the Commission is authorized to grant (Article 81(3)). This "applications flood" was the key to the European resolution of the tension between competition policy and insurance market characteristics: the Block Exemptions.

A regulation authorized the Commission to grant group exemptions for six categories related to insurer practices. The Commission chose to issue exemptions to four of them [Reg. No. 3932/92, O.J. 1992 L 398/7 (hereinafter: Reg. 3932/92)]. For two (establishment of registers and exchange of information on aggravated risks; and agreements on claims settlements), the Commission stated it lacks the experience and the knowledge to assess the legal and economic implications of such block exemptions

but in the future it might execute its authorization to exempt such agreements [OECD, 1998].

The premium calculations exemption [§§2-4b Reg. 3932/92]: the first exemption acknowledges the difficulty of an individual insurer to properly assess average risks and the need to have broad statistical databases. The regulation exempts agreements that establish such databases as well as calculating the *pure premium*; i.e., the average cost of risk coverage (according to probability of the risk occurrence multiplied by its magnitude) without any additional costs, such as administrative or distributive costs. The regulation also exempts agreements for joint studies regarding claims frequency and scale.

But permitting cooperation does not mean that harming competitiveness is acceptable. The regulation includes "checks and balances" in order to prevent this sensitive cooperation from becoming a price-fixing practice. *First*, the statistical premium-base must not be binding in any way. It should be clearly stated that it is merely a recommendation. *Second*, the information contributed by the insurers must be anonymous, illustrative, and should not imply anything about the insurer's identity. *Third*, the suggested premium should only reflect the pure premium. The premise is that if these restrictions are kept, the cooperation will not go beyond what is necessary and even enhance competition (by enabling small insurers' participation).

The policy standardization exemption [§§5-9 Reg. 3932/92]: the second exemption arises from the general complexity of the insurance contract and particularly from the difficulty of the insured to compare offers by several insurers'. It allows standardization of policy conditions by setting a policy model. To prevent the anticompetitive consequences, the regulation defines provisions that must be included: the non-binding nature must be stated and the model should be accessible to anyone. Other provisions must be omitted: any provision regarding self-participation for excess insurance; any clauses that exclude normal coverage or include irrelevant risks under the coverage; provisions granting the insurer the right to unilaterally change the coverage scope or to increase premium rates within the policy's duration; provisions that "tie" the insured to other products offered by the insurer.

Although at first glance such cooperation may seem to be less anticompetitive than price cooperation, this exemption is highly criticized. It has been argued that it directly violates the prohibition of agreements regarding trade conditions [Reich, 2001].

The proponents respond by emphasizing the non-binding nature that enables innovation and heterogeneity.

The critics further claim that "black list" of limitations is based on consumer protection rather than on competition grounds. There are two counter arguments: first, as Article 81(3) implies, consumer protection is one of the aims of competition policy. Second, the limitations facilitate consumers' freedom of choice, to replace their insurer and thereby increase competition [Wulf-Henning, 2000].

The co-insurance exemption: The third exemption concerns co-insurance coverage for certain risks in the form of common coverage of risks or mutual re-insurance [§10 Reg. 3932/92]. This includes setting the commercial premium, re-insurance conditions and common settlement of claims. In order for this exemption to be given, the common market share of the insurers should be relatively low (10% of the relevant insurance product market, or 15% of the re-insurance market)² and an insurer who wishes to exit from this cooperation should be free to do so with only a six month notice. The market-share limitation goal is to assure that co-insurance will not serve as a mechanism to gain market power. Some critics argue that it requires difficult definitions and does not contribute much more than the *de-minimis* exemption, which allows certain agreements between undertakings, as long as they hold no more than 5% of the market share [O.J. 1997 C 327/13].

The security devices exemption allows agreements aimed at establishing a common basis and standardization of security devices [§§14-15 Reg. 3932/92]. Such agreements save the insurers research and development costs, thereby enlarging the market for these devices. In order to prevent the creation of trade barriers that restrict competition, the collaborative technical schemes must be transparent, accurate, justified and proportionate. This exemption is somewhat less related to the special characteristics of the insurance market but arises from the Community's perception that harmonization of standards promotes competitiveness [Wulf-Henning, 2000] since it enables an easy opt-out for the insured without being tied to the former insurer through sunk investments in required safety measures [Reich, 2001].

My assessment of Block Exemptions as a means to settle the policy tension is quite positive. In a way, although they are located in the "competitive" branch, the

² In case of catastrophe or other risks that no insurer is willing to cover alone (such as nuclear reactor accidents), the market-shares are different, and the exemption is given individually.

Block Exemptions are *The New Generation* of insurance regulation at the European level; or at least an important complement to "classic" regulation, directives and national regulations.

The insurers cooperation seems to be a sufficient tool to ease the difficulties these undertakers face, no worse (and perhaps better) than regulation can achieve without jeopardizing the insurers financial stability. At the same time, "checks and balances" protect this immunity, at least theoretically, from abuse by harmful, anticompetitive behavior. The exemptions may even enhance competition by enabling operations by small insurers. The Commission's empirical report supports this assessment [Reich, 2001].

Yet, this is not a perfect solution. Practically, the pretense of distinguishing between allowed cooperation and anticompetitive behavior is unrealistic because the facilitating platform would make the difference nearly un-traceable, at least for a non sector-specific regulator.

Besides, the exemptions are a passive but detailed regulation, which requires constant adaptation in response to changing market conditions, needs, practices and trends. These dynamics may be desirable, but they are costly. It is doubtful if a non-sector-specific authority (as the Commission) can properly assess these changes.³

Finally, the institutional aspect is neglected. Although the directive abolished the prior approval of rates and policy terms, the exemption method does not take into full consideration the fact that insurance is still subject to some degree of active regulation. This might lead to conflicting orders.

3.2.2 US: (Nearly) Full Exemption

Unlike the EU, US law resolves the tension between antitrust and insurance markets characteristics, by preferring regulation to competition. Except for extreme anticompetitive behaviors, state-regulated insurance is exempted from the application of antitrust law.

After declaring at 1868 [*Paul v. Virginia* 75 U.S. 168 (1868)] that insurance is not interstate commerce (and therefore not subjected to the federal law), at 1944 the SC changed its approach and decided that insurance businesses *are* subject to the Sherman

³ Although, it should be noted that the Commission's structure of specific/specialized departments may moderate this difficulty.

Act [*United States v. South-Eastern Underwriters Association* 322 U.S. 533 (1944)]. Since this threatened the industry's cooperative practices, intensive lobbying led (already in 1945) to the enactment of the McCarran-Ferguson Act [15 U.S.C 1011-1015 (1988)] (hereinafter: MFA), exempting regulated insurance businesses from the antitrust law.

There are three prerequisites for MFA antitrust exemption: the practice should be a "business of insurance"; regulated by state, and must not be a boycott, coercion or intimidation.

Business of insurance: the "insurers" are not exempted, only the insurance business. In *Royal Drug* [440 U.S. 205 (1979)] and *Pireno* [458 U.S. 119 (1982)] the SC defined the scope of this definition: a practice falls into the exemption if it transfers risk from the policyholder to the insurer, is part of insured-insurer contractual relations, and "limited to entities within the insurance industry". In practice, SC applies these criteria to exempt necessary intra-industry cooperation.

State regulation requirement: the exemption holds only if the conduct at stake is regulated by state law. The priority of state regulation depends on a few elements: it should be effective [Anderson, 1983]; consistent with the constitution, and as long as the federal law did not override it or clearly indicates that another federal law is preserved notwithstanding MFA [Macey & Miller, 1993]. The exemption is limited to the relevant state's borders; the relevant state is the state whose regulation is applicable is [Anderson, 1983, p. 103]:

"...the state in which the insurer's activity is practiced and has its impact".

Rate regulation is the classic case of state intervention relating to antitrust exemption. Some states set rates for several insurance lines themselves; half of the states apply "prior approval" of rates, increases and decreases proposed by the insurers [Lemaire & Subramanian, 1997]. These strict regulation methods should naturally be exempted from antitrust law. Other methods are "file and use" and "free competition". An interesting question is if a state clearly expresses that rates are open to free competition, insurers' cooperation should still be exempted from the antitrust law. Some argue that this is actually a regulatory omission and therefore there should be no exemption. Others argue that if the state clarifies that it meant for MFA exemption to be preserved, although no "active" rate regulation is applied, it should to some extent shield the insurers from the federal antitrust law [Macey & Miller, 1993].

Other regulations that should be mentioned while surveying US insurance regulations are solvency regulations and guaranty funds. These will be described in the fifth chapter, as a part of the suggested resolution.

The Boycott Exception: the interpretation of this exception has an inverse affect on the scope of the exemption: a broad reading of it may exclude cooperating activities. Yet, to prevent the abuse of the MFA exemption to boycott and of coercive behavior, the SC interpreted it quite broadly. In *Barry* [438 U.S. 531 (1978)], SC held that rate-setting (as a refusal to deal except at the specified price), is not boycott or coercion, as long as no insurer is forced, by threat of collateral punishment, to accept the "recommended" rate.

During the last decade, the MFA antitrust exemption was highly criticized. Some argued that the special characteristics of insurance, and particularly regulated insurance, cannot justify inapplicability of antitrust law on such an enormous segment of the US economy (premiums paid for private insurance in the US exceed \$1 trillion [Abraham, 2005]). The American Bar Association suggested partially repealing of the exemption, leaving only limited "safe harbors" that would enable pro-competitive cooperation [Section of Antitrust Law, American Bar Association, 2006]: insurers will be allowed to cooperate in collecting and disseminating historic loss data but not in rate setting. Policy standardization and other cooperative activities will be permitted only as long as they do not unreasonably limit the insurers' competition and range of insured choice. The State Action Doctrine (see chapter 4) would only protect directly regulated activities.

3.2.3 Israel: No (?) Exemption

Contrary to the EU, and particularly to the US, no broad exemption is granted to the insurance businesses, although they are stringently regulated. Nevertheless, three general exemption methods might be relevant.

The General Exemption in the Antitrust Law: as an important High Court of Justice judgment [HCJ 7721/96 *Igud Shamaey Habituach v. The Insurance Commissioner* (2001)] had clarified, the scope of the IC's authority should be interpreted broadly. According to this judgment, it does not matter if the source for the Commissioner's decision is a complaint that was filed by a policyholder or any other source; he is authorized to give obligatory instructions to correct flaws or to change a practice, to issue an order to a certain insurer or to the entire market. A recent

ratification of this approach was expressed in the 2005 amendment to the Control of Financial Services Law (Article 2(b)):

"The Commissioner may...issue instructions...for all insurers or insurance agents or for certain categories of them".

On this basis, one could argue that insurance practices (at least to the extent they were approved beforehand or instructed by the Commissioner) can be exempted as falling into the general exemption stated in the RTPA, Article 3(1):

"3. Arrangements which are not Restrictive...

An arrangement involving restraints, all of which are established by law".

But the claim that the general exemption covers the Commissioner's instruction was *rejected* in the insurance cartel judgment. The SC stated that although the Article was aimed at resolving conflicts of rules, the mere fact that an industry is regulated does not immediately exempt it. Only statutory arrangements that *themselves* create a trade restriction overcome the ban, through Article 3(1). Even then, an effort should be made to settle the contradiction through interpretation [CrimA 4855/02 *Israel v. Borowitz et al.* and Cross Appeal (hereinafter: CrimA 4855/02)].

Block Exemptions: the RTPA 6th amendment (2000) granted (Article 15A) the IAA GD the power to issue block exemptions (after consulting procedure and approval by the Minister) if

"The restraints... do not reduce competition in a considerable share of the market".

Contrary to the EU block exemptions, the Israeli arrangement does not consider the benefit from the trade restriction; the lack of this element had been criticized with regards to insurers' cooperation [Reich, 2001]. Few Block Exemptions were given and implemented by the RTPA. A Block Exemption that was issued (at 2004, amended at 2006) [IAA publication No. 3010571] exempts competitors' agreements for research and development, and therefore may be very relevant for insurers. But so far, the GD did not use this method to direct exemption for any insurance line or practice.

Individual Exemptions: one explanation for the lack of consideration for public benefit with regards to block exemptions is that the GD is authorized to grant individual exemptions, based, among other, on this ground [Reich, 2001]. Few individual exemptions were given to insurers. An important example is the exemption that was given to the Israeli Insurance Association and to "any insurers that wish to join it". The exempted arrangement is a common system for clearing obligatory payments

(according to statutory "balance payments" stated in the "Compensation for Victims of Road Accidents Act, 1975"). Based on the assumption that each insurer would be obliged to pay for some accident damage and at the same time would be entitled to indemnification for other accident damage (according to drivers' guilt), the Association initiated the establishment of the above-mentioned system, which allocates these payments on a non-guilt base, but rather according to a set of "arrangement rules". After assessing it would not harm competition, the GD exempted this system [IAA publication No. 3018123], while subjecting it to four conditions: application of the system on limited types of accidents; prohibition of any changes in the system; outsourcing the system to an independent body in order to prevent facilitating practices; demanding equal service to all insurers that will join it, whether or not they are members of the Association.

Several decisions imply that the individual exemptions have the nature of a very detailed block exemption, similar to the EU method. A possible explanation to the IAA's avoidance to grant block exemptions to the insurance industry is the need for greater scrutiny of a regulated market in a small economy, as generally suggested by Gal [2003]. I find that the "individual" definition of the exemption in the IAA practice relates to narrowing of the arrangement itself, and not to the identity of its participants.

3.3 The Institutional Aspect: Authorities Map

The institutional structure is a crucial element. It may strongly influence the delicate equilibrium between the insurance industry's needs and the competition policy applicability upon this market. This section surveys the authorities' structure in the observed jurisdictions and analyzes its adequacy for achieving a resolution of policy tension.

3.3.1 EU: Competition Authority with No (?) Partner

The implication of the EU shift towards single insurance market upon institutional structure of the authorities (competition authorities and insurance regulators) has not (yet) been well-researched. I suggest that this structure is incomplete, or at least unbalanced. While there is an existing *insurance regulation policy*, alongside the *solid competition policy*, a great difference exists at the *authorities' level*. The competition policy is constantly applied by the Commission and the Courts; but there is *no parallel insurance regulator* at the European level; no authority was established as a counter-balance to the Commission. Regulation remained

a prerogative of the MS, according to the directive's guidelines (which should have been established by them before their coming into force). At the same time, the directives weakened the national regulators by substantially narrowing their powers.

The importance of this lack of a European-level regulator is even greater since the directives are intended to result in insurance services being provided in an inter-state setting. It is an old debate, whether states, based only on minimal harmonization, can adequately regulate services that are provided at the European level. Recently, an indication was given that there is a tendency to unite economic regulations under one supervisory authority [Directive 02/87/EEC: (2002) OJEC 2003 L 35/1]. Such development potentially corrects the above-mentioned imbalance and maintains the old structure of separation between competition authority and sector-specific regulation.

Meanwhile, it seems that the abolishment of substantial national regulatory powers, without the establishment of European-level insurance regulations, simply shifted the regulatory weight to the commission as the authority that applies and controls the block exemptions. It seems that though no such goal was expressed, the Commission serves as a super-regulator on the European level.

3.3.2 US: Two Authorities with What Cooperation?

As previously mentioned, the antitrust authorities include the FTC and the DOJ on the national level; the antitrust departments and state Attorney General on the state level.

The insurance regulators scheme is much more complicated, including formal and informal organizations. *Officially*, each state has an insurance department, headed by the IC (chosen by citizens or appointed by the governor) including actuaries, accountants and insurance examiners. These departments are continuously involved in licensing and ongoing supervision, whose level differs amongst the states.

The *informal* insurance regulation bodies are strongly connected to the formal authorities: the National Association of Insurance Commissioners (NAIC) was established in 1871 [Mirel, 2005]. It is a private, nonprofit organization of all the Commissioners. It serves as a platform for information exchange and coordination of regulatory activity. It develops legislation models, establishes standards and assists the state departments. The main cooperation relates to the insurers' financial conditions: NAIC Insurance Regulatory Information System (IRIS) created and updates a set of criteria to assess an insurer's solvency (to be discussed in chapter 5). NAIC facilitates

regulatory uniformity, and thereby constitutes a substitute to federal regulation. Yet, it should be noted, that the decisions are not necessarily correlated to insurance regulation's real needs, since the voting mechanism (one vote for each state) does not reflect the fact that a few states provide more than half of the insurance market.

Another informal organization is an advisory body, the Insurance Services Office (ISO) that collects information from insurance companies in a database. In the past, ISO provided rating, actuary services and suggested policies; just as the European block exemption is meant to facilitate. ISO also reduces rate-setting expenses. Yet, after its service had been criticized as affecting interstate trade by price-fixing [*South-Eastern Underwriters ASS'N*, 322 U.S.533 (1944)], ISO stopped providing recommended rates and limited itself to publishing trended loss costs, while the insurers must develop the rate factors themselves [Lemaire & Subramanian, 1997]. Today, its activity is highly scrutinized by antitrust authorities [OECD, 1998].

3.3.3 Israel: Two Authorities, Informal Cooperation

In the past, the Israeli IC could promote a "quasi-cartel" among insurers, by recommending that the Minister enact ordinances (with permission of the Finance Committee of the Israeli Parliament, the Knesset) that would set prices, uniform reductions, etc. But after the IAA was established, the institutional structure changed. The GD and the appellant tribunal became the only institutions authorized to allow certain trade restrictions.

The intensive involvement of the Commissioner in the insurance industry was highly criticized in the State Comptroller's Report [State Comptroller, 1991], emphasizing that the separation between insurance regulation and the trade restrictions control should be preserved. The insurance cartel investigation was a corner stone of the turning point, long before the insurance cartel judgment was given.

Today, the two authorities work with a high degree of cooperation. According to the Head of Elementary Insurance department, Mrs. Lee Dagan [Interview, 2nd July 2006], the cooperative practice contains several phases. Firstly, a need is located by the insurers, the insurers union or the Insurance Commissioner. Secondly, a resolving method is designed to deal with it, such as the establishment of the "Database for the Compulsory Vehicle Insurance in Israel Proposed Tariffs" that dramatically increased the transparency of this insurance, and led to higher competition and lower rates. Thirdly, in case the proposed method has potential affect of trade restriction, it is

brought to the consideration of the GD, similarly to a pre-ruling procedure. Fourthly, the GD exempts the practice (formally) or supports it (informally).

I find this practice quite efficient, but yet, insufficient. It seems that the cooperation is based on recognition that the two authorities are complementary but its unofficial nature exposes it to the possibility of sub-cooperation. The method of detailed block exemptions might be more efficient than limited individual exemptions, especially if these are performed by both authorities.

4. Regulatory Conflicts as Defense Claims

The incompletely resolved tension between competition policy and insurance regulation, and the authorities' conflict that exists, at least to some extent, gives rise to some defense claims in competition trials.

4.1 Comment: "Great Minds Think Alike"

One possible claim is that the anticompetitive outcome is not a consequence of anticompetitive behavior, but results from the "identical platform", created by the regulator involvement and/or approval granted by the IC to the undertakings.

The stricter the regulation, the greater the chance it will lead to parallel behavior by different undertakings. As long as this parallelism is a consequence of reaction to market and regulatory conditions, contrary to deliberate collusion, it is usually not prohibited.

Therefore, it should be taken into consideration, that the typical high-level intervention of insurance regulators, may create difficulties for courts to assess whether the concerted practices by insurers results from the regulatory identical platform, or from a forbidden agreement that established an insurers' cartel. The economic implication of this is not only an increase of litigation costs, but more importantly, a greater chance for successful collusion, before it is discovered.

4.2 State Action

The second possible claim focuses on direct contradiction: in case the regulatory orders or approvals simply oppose competition law when the later is fully applied (no exemption).

In US law, the MFA exemption apparently eliminates the problem: if insurance business is regulated, there is no legal contradiction with antitrust policy, unless some conduct brutally violates it. Yet, the "state action" doctrine, which is aimed at tackling problems of contradicting regulations, was also argued by insurers.

This doctrine was originally initiated in *Parker v. Brown* [317 U.S. 341 (1943)]. It is, in essence, a conditional immunity of regulated conduct through the application of the antitrust law. The two accumulated prerequisites for this claim to be raised are related to the level of state intervention. Firstly, the *clear articulation* requirement: There should be an "affirmative policy to allow anticompetitive conduct"; though the specific conduct should not necessary be directly required by the state. Secondly, the *active supervision* requirement: the suitability of the anticompetitive conduct to the policy should be reviewed by an official state regulator.

Regarding to the tension between antitrust and insurance regulation, the exemption's scope granted on the basis of state's action doctrine is quite broad. In *FTC v. Ticor Title Insurance Co.* [504 U.S. 621 (1992)], the Supreme Court expressed willingness to exempt the anticompetitive activity of price-fixing by private rate-bureaus, but defined that in case of mere veto regulatory power, a defendant that claims immunity under the state action doctrine [Macey & Miller, 1993, p. 62]

"...must show that state officials have undertaken the necessary steps to determine the specifics of the price fixing or rate-setting scheme, and the mere potential for state supervision is not an adequate substitute for a decision by the state".

Yet, in the *Ticor* case, the SC found the regulatory review insufficient and therefore rejected the state action immunity claim. The supervision was nearly artificial; the rates were respected by the regulator with a very low level of examination, if any.

The possible range of state involvement in rate-setting (or in any other anticompetitive conduct by insurers) has a parallel range of likelihood that the doctrine will immunize the undertakings. In case the state sets rates, or requires cooperated rate-setting, the insurers' rate-similarity is obviously protected by the doctrine. In case cooperation is initiated by the industry but clearly allowed by regulation, the doctrine would shield the activity if there is sufficiently active supervision. But in the case of free-competition model of insurance rate-setting, and in the case of meaningless supervision, the doctrine will not be applied [Macey & Miller, 1993].

The origin of the doctrine in the US is the federalism principle of maximal state sovereignty (and the acknowledgement that this sovereignty might lead to contradiction between federal antitrust law and state regulation). In the EU, on the contrary, state regulation is considered a potential threat to the common market [Gal & Faibish, Unpublished]. The aspiration that underlines the Treaty, to protect the free flow of goods, services and capital, led to the creation of guidelines (Article 3(1)(g), Article 10) for the MS to avoid anticompetitive enactment. Based on these principles, the EU has a narrower scope of custody: there are no parallel measures to the state action doctrine; the closest provision of the Treaty, Article 86(2), only creates an analogous effect.

According to Article 86(2) (known as the "Public Mission Exemption") undertakings that are "*entrusted with the operation of services of general economic interest*" or "*having the character of a revenue-producing monopoly*", are subjected to the competition law only to the extent it does not "*obstruct the performance, in law or in fact, of the particular tasks assigned to them*".

Yet, it is unlikely that this *lex specialis* would immunize private insurers on the basis of the important social functions they serve. First, because the definition "entrusted" is narrowly interpreted; by analogy to the banking industry, mere prior-approval by the insurance regulator will not be considered as fulfilling the "entrusting" requirement [Bellamy & Child, 1987]. Second, the "general economic interest" is also analyzed as a broader concept than provided by a private insurer; the ECJ applies a proportionality test, thereby examines the *essence* of the regulatory limitation, contrary to the examination of *procedural* perfection carried out by US courts [Gal & Faibish, Unpublished].

Although there is some equivalence between state action doctrine and Article 86(2), the EU case law does not focus on the undertakings' immunization. Rather, based on limitations provided by the Treaty (Article 86(1), Articles 87: "state aid control"), it emphasizes the obligation of MS to avoid jeopardizing the competition and free market objectives of the Community either by anticompetitive enactment or by maintaining any measures inconsistent with the Treaty.

It appears that in the courtroom, there is one main difference between the US and the EU approaches. It relates to which party would be affected by the competition law in case the regulation is not active enough to establish the immunization of "state action doctrine" or "general economic interest". In the US, the undertaking would be

forced to comply with, or bear the burden of antitrust law, in case his excuse of "regulatory orders" relies on mere passive regulation. Meanwhile, the FTC efforts against a legislator that enacts anticompetitive have mostly only an advocacy nature [Pate, 2005]. Contrarily, in the EU, although the personal obligation is not completely neglected (since unjustified regulation does not immunize from violation of competition law [13/77 *GB-INNO-BM v. ATAB* [1977] E.C.R. 2115]), the regulating state is the ECJ's focus. Not only that the ECJ uses the platform of cases to review the legitimacy of the "general interest" and the proportionality of the regulation, but it may accuse the Member State *itself* of being a mere "rubber-stamp" [267/86 *Van Eycke v. Aspa* [1988] E.C.R. 4796].

4.3 Israel: Had The Lesson of The Insurance Cartel Case Been Learned?

The Israeli insurance market went through a great shock when, after three years of investigation, eight insurance companies (holding a large percentage of the Israeli insurance market), fourteen of their managers and the Israeli Insurance Association were charged with (criminally) violating the antitrust law. Six of the companies, their managers and the Association, *confessed, were condemned and punished* by an agreement with the prosecution. The remaining two companies and their managers chose to go to trial. They were charged with participating in a wide cartel that ruled the market of four non-life insurance lines during 1991-1993.

One of the main arguments of the defendants, both in the first instance [CC (Jerusalem) 471/97 *Israel v. HaPhoenix Insurance Company LTD.*] and in the appeal [(CrimA 4855/02)], was that the charges and the evidence cannot be judged "out of context", without taking into consideration the market and regulation environment. The defendants claimed that the IC was highly involved in uniform rate-setting practices and their enforcement, and encouraged close relations between the insurers (including information exchanges and mutual complaints), all in the light of severe insurance crisis during the previous few years, that led to the bankruptcy of three insurers that held a 40% accumulated market share.

The district court found the defendant guilty on most of the charges. But the judgment regarding the vehicle insurance line was divided into five sections, four related to the insurers' conduct in 1991 and one to their conduct in 1992. The court acquitted the defendants of three of the "1991" sections. The acquittals were mainly based on the *involvement of the IC* with the insurers' cooperative practices. The court

noted that a concern for the stability of the insurers, contributed significantly to the uniformity of rates in this insurance line. The Commissioner initiated a change in the rate structure, approved new rates-set that was suggested by one insurer, and ordered the other companies to file their rates proposals in a similar structure. On appeal [CrimA 4855/02, §122], the SC reversed the condemnation regarding the 1992 trade restriction on the basis of a reasonable doubt, regarding whether it was prohibited collusion or legitimate price leadership. It further based the additional acquittal on the *continuity of the involvement of the Commissioner*, the fact that the Commissioner informed ("for the sake of fairness and equality") insurers regarding approvals given to others, and the difficulty in separating legitimacy of the insurers conduct under the Commissioner's orders in 1991, from their cooperation in 1992 [CrimA 4855/02, §146].

It is more than reasonable to interpret that the quite moderate verdict was given, among other considerations, in light of the Commissioner's involvement in the insurers' conduct and their reliance upon it as state legitimacy.

Although the legal procedures lasted until 4/2006, it is not too early to assess if the lesson had been learned (since the investigation started in the beginning of 1993, and the first instance hearing began in 1997). My impression is that a lesson had been learned, but not "the lesson": the changes in policy at institutional levels are positive, but insufficient:

The IC's awareness and responsibility to competitiveness in the industry increased, the legislator enacted the "Increasing Competition Act" that included competition consideration in "Control of Financial Services (Insurance) 1981 Law". The two authorities constantly interact, sharing opinions and discussing possible effects of regulation and competition policy on the insurance market. But this cooperation is not formulated by the legislator, and there are no completely synchronized guidelines for the mutual application of antitrust policy and insurance regulation. Although under the current circumstances it is not likely that the IC would be actively involved in insurers' anticompetitive behaviors, the borderlines are still not completely drawn.

5. Conclusion: Resolution suggestion

None of the mechanisms used to resolve the tension between competition and insurance regulation was found to be perfect. This chapter's aim is to combine current means and additional increments into a coherent regulation-competition policy and institutional scheme. I believe that such a resolution cannot be "binary": since competition and insurance regulation are, on one hand, complementary, and on the other hand, inherently in conflict, the solution must be a golden mean.

The core of this suggestion is a mutual influence between insurance regulation and competition. A Rawlsian methodology called "Reflective Equilibrium" could be applied [Rawls, 1999]: when two (or more) principles require application, but are contradictory to each other, they should be settled in a back and forth movement between them, by adjusting and sometimes abandoning some of their elements. This eventually ends-up at an equilibrium point of acceptable coherence, which reflects the original stand-points. The use of Reflective Equilibrium is innovative in comparison with the common methods used to resolve the tension at stake. Arguably, it even contradicts the popular means; i.e., proportionality and interpretation. The *proportionality test*, applied by the ECJ, "allows" regulation, and even exempts regulatory activity from the competition liability, only as long as the damage to competition is proportional. The *interpretation method*, applied in all the three examined jurisdictions, is aimed at harmonizing regulation with a broader competition-oriented approach.

Although the outcome of these methods and of the Reflective Equilibrium process might be the same, the starting point is different. While the presumption that underlines both of these methods is that competition is a prior goal to achieve an efficient functionality of the market [Gal & Faibish, Unpublished], Reflective Equilibrium gives the two branches the same preliminary importance and finds the equilibrium between them by mutual influence one upon the other. This will be the layout for the following analysis.

5.1 Policy Tension Resolution

The policy resolution is divided into an active branch (the regulatory intervention in the insurance market) and a passive branch (the exemption of insurance from the competition law).

5.1.1 Active Regulation

Keeping in mind the two general goals of insurance regulation, stability assurance and consumer protection, I shall divide the optimal tuning of active regulation by two categories: chronological and essential.

There are three phases of intervention in the insurance businesses: ex-ante regulation, ongoing regulation, and "post mortem" regulation (after an insurer became insolvent).

The ex-ante regulation is essential for solvency assurance. It affects, at the most, the competition *on* the market (contrary to ongoing regulation, which affects the competition *within* the market) [Gal & Faibish, Unpublished] by determining which applicant can compete with other insurers. Therefore, various ex-ante measures are acceptable: minimum capital and/or deposit requirements, and other licensing conditions. Of course, ex-ante regulation might be instituted on behalf of currently operating insurers, but in the long run, it does not create unfair advantages.

"Post mortem" regulation is crucial for consumer protection. Due to the heightened effect insurers' insolvency has on the policyholders as creditors, especially in life insurance, it is necessary to assure their protection from this scenario. This type of regulation may even enhance competition: the more the insured are protected from this extreme situation, the less the insurers need their ongoing operations to be regulated, leaving this realm subject to competitive forces. Therefore, adopting the funds mechanism is suggested. But competition considerations should be taken into account in designing the structure of these funds. I believe that financing by the remaining insurers in the market, inversely influences competition: it may lead insurers to anticompetitive cooperation in order to prevent the collapse of another insurer, in their attempt to avoid the above-mentioned burden. I suggest that the "post mortem" regulation would be strongly connected to the "ex-ante" regulation, by using deposits to finance the fund's safety-net.

The ongoing regulation is the most impeding to competition forces, and therefore it should be subjected to higher influence of competition principles.

Solvency Regulation, for the sake of stability, may be considered as the core of insurance regulation. Similar to ex-ante regulation, it does not substantially contribute to the regulatory-competition tension.

A comprehensive method enabling and assisting regulators to evaluate insurers' solvency should be part of any regulatory scheme. IRIS (Insurance Regulatory Information System), which was established by NAIC, is a good example of such a method and adopting it is recommended (although adjustments to different markets may be required).

Briefly, IRIS is designed to assess the insurers' solvency according to eleven ratio-tests, examining overall ratios, profitability, liquidity and insurer reserves, using their annual statement as a database. Each ratio has a recommended value-range. The values are based upon studies that analyzed insurer crisis (companies that turned insolvent or suffered great financial difficulties), and are constantly revised [Lemaire & Subramanian, 1997]. A few examples of IRIS tests:

1. Surplus ratio along years: according to the NAIC values, the ratio of changes between the current-year's surplus and the prior one should be between -10% and +50%.
2. Changes in writing: insurer's instability is reflected in a substantial increase or decrease of written premiums. Therefore, according to IRIS recommendation, the ratio between current-written premiums changes and the written premiums of the previous year should be in the range between -33% and +33%.
3. Reserves deficiency and surplus: ratio between the (estimated) current reserve deficiency and the current surplus. According to IRIS values this ratio should not exceed 1:4.

When an insurer's index falls outside the recommended ranges it is in danger of insolvency and therefore, should be subjected to stricter scrutiny, up to full intervention by replacing the management in order to prevent bankruptcy.

Rate regulation is aimed to achieve both stability and consumer protection. Under competition reflection, rate regulation seems much more problematic than solvency regulation. It dramatically diminishes the competition among insurers and has

high costs: First, the inherent risk of error. Second, rate assessment is a costly process, particularly for the state that cannot spread these costs and pass them onto the consumer (as insurers are able to do). The interests that support rate regulation are strongly biased: consumers wish to gain a rate roll-back, regulators try to increase their power and budget, and insurers favor rate-regulation because they believe that they will be able to influence the regulator's decision and at the same time gain immunization from competition in general and from competition law liability in particular [Macey & Miller, 1993]. Therefore, competition-regulation equilibrium should include only minimal rate regulation. In light of the importance of competition, it should mostly serve as solvency assurance and crisis prevention; consumer protection should be achieved by other means. The regulator should intervene only in case the rates the insurers set are substantially too high or too low ("file and use" method), or when an insurer failed to fall within the recommended ranges of solvency tests. This still requires high administrative costs and is still exposed to errors, but I believe it is the lesser of two evils.

Policy regulation is one of the means to protect consumers. The restrictive impact it has on competition is relatively small. Therefore, policy regulation can be easily contained at the regulation-competition equilibrium point. It should define minimal requirements of what should be included in and/or excluded from insurance policies. It may be used to establish commercial norms, such as mandatory disclosure and explanatory requirements. Lastly, it may add compulsory insurance segments that are otherwise exposed to the danger of elimination, like catastrophe risk insurance.

5.1.2 Passive Regulation

Neither full exemption of regulated insurance businesses from competition law (as theoretically exists in the US⁴) nor full standard application of competition law, are compatible with the Reflective Equilibrium idea. Given the special characteristics of the insurance industry, partial exemptions (such as the EU block exemptions) are desirable. This method enables the operation of necessary cooperation, but strictly guides what shall be allowed and what are the legitimacy limits, according to the reflection of competition.

The legitimacy of cooperation granted must be correlated to the industry's needs. *Firstly*, premium calculation activity should be regarded as the key for insurer

⁴ Although the extent of exemption is restricted by courts.

efficiency. It is suggested that the exemption would be limited to the real need for cooperation; i.e., only statistical information sharing (less than the current extent of the EU premium calculation exemption). *Secondly*, co-insurance exemption should be allowed only for risks that single insurers cannot offer; the market share limitation is necessary but insufficient. *Thirdly*, unlike the EU safety measures exemption, the effect of competition on other markets (such as the safety products market) should be taken into consideration. The effect of complementary products' cross-competition might lead to the same outcome as exemption, without immunizing the insurers from competition law liability. *Fourthly*, further steps should be taken, such as exempting a mutual clearing system between insurers.

5.1.3 The Regulatory Scope

Such detailed suggestions for policy, combining regulatory and competition spheres, would be useless in the current era of cross-borders insurance services unless it would be applied at substantial levels. If this combination was adopted in one state, insurers would face difficulties to compete with other companies that benefit from full exemption and immunization, or subjected to much less detailed and guiding exemptions. This regulatory arbitrage might cause market distortion: the insurer that is subjected to less stringent regulation and intervention, or is able to cooperate freely with its rivals, would have a relative advantage, not necessarily associated with better skills. At the very least, the policy guidelines should be shared in the same level the competition policy is applied (federal or Community).

5.2 Authorities Tension Resolution: Economic Analysis of Possible Schemes

The authorities' scheme has a great impact on the functionality and efficiency of insurance competition-regulation policy. Based on the Reflective Equilibrium process, this section analyzes which institutional structure would be the best to execute the above-mentioned regulatory-competition mix.

There are two main possible structures to apply the suggested policy: first, it can be supervised by one authority; either the competition authority or the insurance regulator that would execute both the competition policy and the insurance regulation. Second, the regulatory tasks can split between two authorities; this is the "Twin Peaks Model" [The Israel Democracy Institute, 2006].

The US regulatory-competition scheme, although it apparently has two authorities, is similar to the first one. The MFA exemption is actually a delegation of competition considerations to the IC, assuming it would protect the competition in the insurance market, or that the market structure is diverse enough to establish strong competition in any case. *State action* and the *boycott exception* serve as safety valves for conflicting orders or brutal antitrust violation. At the other extreme, Israeli law chooses the dual supervision path. The EU tends to have two authorities (although not at the Community level) with only limited exemptions.

Several economic arguments support the single authority model. Firstly, it enables the supervisor complete oversight of the supervised industry. Recently, the US SC supported this view: in *Trinko* [540 U.S. 398, 124 S. Ct. 872 (2004)], it provided a cost-benefit analysis to determine whether antitrust scrutiny should be added as a task for a sector specific regulator. The analysis elements are the capability of the regulator to protect the necessary amount of competition in the regulated market; and the confidence that adding external antitrust scrutiny will actually increase competition [Gal & Faibish, Unpublished].

Secondly, a single entity operates consistently. Consistency is crucial for setting market guidelines; it enables insurers to foresee the consequences of potential cooperation and to design the intra-market relations accordingly. Under dual supervision, there is an inherent potential of conflicting orders that cannot be complied with simultaneously. Although there are some escape mechanisms, this leads to a loss of essential synergy.

Thirdly, it is more transparent and therefore more subject to inspection both by the public and by other authorities. Arguably, if regulatory bias is unavoidable, the fewer official positions means fewer irrelevant considerations, and less bias and corruption.

Lastly, a unified system saves substantial administrative costs by preventing overlaps and duplication of invested resources. Compared to dual supervision, a single authority would gain an economy of scale in research expenses and human resources.

Yet, the advantages of dual supervision are greater than the disadvantages presented in the above-mentioned arguments. The alternative of a single authority suffers from too many substantial flaws. It is suggested that a "Twin Peaks Model" should be adopted:

The conflict of interests phenomena (regulatory capture, regulator identification with the regulated industry, and the pressure of interest groups) are exaggerated when the power is gathered under one authority. Whether the power is given to the competition authority or to the insurance regulator, insurers would attempt to affect decisions. If the pressure would include blackmail or bribes, the concentration of powers under one authority may lead to a greater distortion, compared to a dual structure.

The conflict of interests results not only from pressure by interest groups. It is essential since each authority is goal-oriented. The goals themselves contradict: sector-specific regulators try to increase insurers' market power (for sake of solidity), while competition authorities aim to reduce it. Unification of powers will blunt these orientations, thereby might restrain the ability to accomplish both competition and regulation tasks [OECD, 1999].

Both insurance regulation and competition protection require specialization. Insurance supervision is a complicated task that includes examination of complicated solvency data, assessment of intra-market cooperation needs, and evaluation of the adequacy of the insurers' practices. It is unlikely that a competition authority, controlling the competition aspects of the entire market would have these qualities.

Competition policy enforcement is also a matter of specialization. The assumption that any sector-specific regulator can apply competition considerations [Het, 2000] is misleading. Adding competition assurance to the insurance regulator's tasks may substantially harm competition maintenance. The above-mentioned *Trinko* solution is difficult to apply in practice: it is costly and slow to assess the competition-protection abilities of the regulator [Gal & Faibish, Unpublished]. Meanwhile, the market structure might be irreversibly distorted.

The two authorities serve as a "checks and balances" mechanism for each other. Whether or not it results from their differences in goals or practices, the two authorities pull in different directions, thus maintaining a market balance. Each authority examines, and sometimes attacks, the other authority's decisions by raising public discussion; bringing the debate to higher-level authorities (such as the ministry or legislature) or by settling the conflict in court. In either case, the market equilibrium benefits by the Twin Peaks Model.

5.3 Constant Mutual Influence

*"The wolf also shall live with the lamb,
and the leopard shall lie down with the kid"*

[Isaiah 11:6]

The Reflective Equilibrium process can be used to create an operational method for the Twin Peaks institutional scheme.⁵ It is suggested that the two authorities would have a constant mutual influence upon each other on two levels: policy designing and enforcement.

5.3.1 Policies Designing

The suggested regulatory policy is naturally divided between the "Twin Peaks". Active regulation, that requires advanced specialization in the insurance business, should be subjected to the insurance regulator. Passive regulation, which draws the borders between the industry's needs and prohibited anticompetitive behavior, should be under the scrutiny of the competition authorities.

This division does not mean a full separation. With mutual ongoing influence, considerations of the "other" branch would be represented by the "other" authority. In this way, both the regulation policy and the competition policy will be "market oriented" instead of "competition oriented", or "industry oriented".

Several practical issues can demonstrate the workability of constant mutual influence.⁶ The competition authority should advocate and consult the regulator concerning the impact of its decisions upon competition in the insurance market. The regulator, as the "insurance specialized body", would be involved in the process of examining and updating the scope of exemptions. The IC's opinion may be required for making decision regarding insurers applying for mergers.

In practice, the Israeli IC and the IAA have informal cooperative interrelations. A recent amendment to the Israeli law included competition in the IC's considerations in

⁵ For an extended discussion of the relations between regulators (in general) and competition authorities, see: Gal & Faibish (unpublished, will be published soon), and OECD 1999.

⁶ For an extended discussion, see Gal & Faibish, (unpublished, will be published soon). They suggest six principles that can be applied by courts and mainly by competition authorities, to assure that the regulatory bodies do not overstep their bounds. Amongst others, they suggest that competition authorities should have an advocacy role in the legislation stage of sector-specific regulation, as well as a mandatory role in regulatory proceedings, and institutional standing at judicial proceedings.

licensing decisions. The FTC also has advocacy and advisory roles [OECD, 1999] and the German Cartel Office as well serves as a "watchdog" over the IC's supervision. But most of these interrelations are not formal.

It is suggested that these interrelations should be legally formulated, so as to establish these checks and balances as an official link in the chain of insurance regulation-competition.

By saving costs, mutual influence mitigates an important economic disadvantage of the Twin Peaks Model. Although administrative resources are still doubled, such synergy would improve the efficiency of the authorities' structure. It increases certainty, reduces the errors risk, and, in the long run, minimizes the economic outcomes of the authorities' conflict, such as the use of the state action doctrine in competition trials.

5.3.2 Enforcement

The mutual influence will be complete if the authorities can cooperate not only in the proposal but also in the enforcement phase. This suggestion is not equally mutual, since competition enforcement requires more assistance from the insurance regulator, rather than the other way around.

The potential contribution of the insurance regulator is mostly in preserving the borders of legitimate cooperation set by the competition authority. The IC's specialization can turn the "unrealistic pretence to distinguishing between allowed cooperation and anticompetitive behavior" (see chapter 3) into a realistic one. A possible way to achieve this is to require the presence of the insurance regulator, as the delegate of the competition authority, at industry meetings. If this is too costly, or too intervening, a more moderate version of cooperative enforcement can be applied, such as joint examination of insurers' applications for exemptions etc. The final decision would be made by the (relevant) single authority, but the operation would be cooperative.

5.3.3 Dispute Settlement

In the long run, the mutual ongoing influence method would dramatically minimize the chances of conflicting orders, and nearly eliminate the use of such an argument as a defense claim. But contradictions are still possible; especially during periods when economic regimes shift towards this method. It is a matter of process. Meanwhile, an outside, independent mechanism to resolve conflicts is still necessary.

Courts are the institutions that have the power and the competence to decide whether the insurer's activity falls into a known exemption, or not. The "boycott" as a borderline between right and wrong, is exclusively subjected to the court's decision. State action immunization is also granted by courts.

Yet, courts are not the perfect answer. An economic analysis even implies that it is a bad mechanism: it is an expensive system, which requires substantial operational costs, mainly administrative. It induces both the insurers and the accusing authorities to invest tremendous resources in litigation. Above all, it is a "post facto" instrument, thereby creates uncertainty. The liability threat may deter insurers from urgently-needed cooperation. On the other hand, insurers may also try to rely on certain vagueness, assuming that in court it may serve them as a defense.

These flaws create motivation for the expansion of the "Constant Mutual Influence" method. Similar to the pre-ruling function of some competition authorities (FTC, IAA), a joint ex-ante dispute settlement might be beneficial. An integrated body, based on representatives of both authorities, can discuss policy conflicts and immunize insurers from future accusations of competition law violations. It would shorten and ease the time-consuming process of getting the "twin peaks" separate support and would reduce the internal litigation costs (although not completely eliminate them). Since the nature of such a body would be mostly functional, its decisions should not become a binding precedent, but only an ad-hoc solution, for the insurers' immediate cooperation needs. After the urgency has diminished, this cooperation should be subject to the normal approval procedures.

6. Summary

Both insurance regulation and competition protection are economically justified, but are they compatible? This research showed the roots of the tension between these two branches. It surveyed the how policy and authority tensions are dealt with by the law and by the courts in the three jurisdictions. However, an economic analysis found that none of these jurisdictions came up with a perfect solution. In a layout of the Rawlsian "Reflective equilibrium" methodology, the conclusion suggested a fine-tuned policy of combined insurance regulation and competition, and provided an institutional model of "Twin Peaks", a dual authority structure. Furthermore, an operational method named "Constant Mutual Influence" was developed in order to overcome the economic

flaws of the institutional structure. The entire proposal is aimed at improving the economic aspects and the welfare maximization of the concerted application of insurance regulation and competition enhancement and protection.

Several more issues are worth mentioning: Firstly, during the past decade, economic regulation is in transition: many jurisdictions tend to unify the financial market regulations; bringing insurance, banking and securities under a super-regulator. This trend results both from the similarity in importance and characteristics of these markets, and from the increasing cross-services they offer. However, I left discussion of this development out of this study. The reason is that these unifications are between financial regulators but preserve the separation from competition regulation; i.e., prohibition of trade restrictions, dominant position abuse and mergers control. In a few years, after these changes will stabilize, it would be interesting to examine the affect of these unifications upon regulation strength and its interrelations with competition policies.

Another idea for further research is the ongoing internationalization of insurance services and its affect upon competition-regulation tension. Insurance is becoming more and more a cross-border service, not only in the wide federal or at Community levels but worldwide as well. Thus, the scope of the regulatory policy might go way beyond the inner, national or Community market. Alternatively, it would surely affect the local intra-industry competitions. It is a subject for further research; to analyze the impact of this development on regulation, competition and the efficiency of the insurance market. Of special interest is how these changes would affect the regulatory-competition structure of small economies and their relationships between their insurers.

This study implies that the economic interests sometimes pull in opposite directions. But it should be remembered, that there is an overall aim of efficiency and maximization of social welfare. The question is only how to achieve the greatest synergy between the different ends. The conflict is not only apparent but it is not a complete "Black or White" debate. The golden path that combines the aims of both insurance regulation and competition should be found, and, as I see it, it is not out of reach.

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