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Model – Con Keating

There is a single long term product offered by all insurers.

The effect of regulation upon the insurer is to raise the costs of production. This operates through two channels. Firstly the lower investment returns from the reduced investment opportunity set arising as a consequence of risk based capital requirements which have differential effects among insurers arising from their initial financial strength (the regulator effort is a multiplier to the RBC level costs) and secondly the dead-weight costs of regulatory compliance, which include management rents.

The insurance industry is a single representative agent. This is plausible as the barriers to entry are high and the insurance market exhibits limited competition in long term products. This will then be expanded to a distribution of insurers distinguishing themselves by their credit standing to examine insurer specific effects.

The insurer cannot renegotiate the pricing of existing contracts, the book of business in force. This lowers the credit standing of all insurers but to varying degrees. The insurer passes all marginal costs on to new policyholders in the pricing of new policies.

Demand for new policies is dependent (and increasing in) upon their quality. (Affordability is not an issue to potential policyholders?) The quality of new policies is a function of the new policyholders' perception of the efficacy of the regulator's actions in increasing quality. (Not all of the increased price is perceived as a quality increase) The increase in price of a policy is a signal of lower quality – only the strong can absorb regulatory effects.

The model may be extended to loading factor policies. The model may be extended to include new business volume / capital constraints?

In many situations aggregate demand for the insurance policy will be lowered – cost to insurer but social welfare cost? Affordability as a determinant?